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ANALYSIS OF THE FAILURE OF SUPERIOR BANK, FSB, HINSDALE, ILLINOIS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

ON

THE ANALYSIS OF THE FAILURE AND IMPLICATIONS OF SUPERIOR BANK, FSB, HINSDALE, ILLINOIS, FOCUSING ON THE NEED FOR CONTINUED REGULATORY VIGILANCE, MORE STRINGENT ACCOUNTING, AND CAPITAL STANDARDS FOR RETAINED ASSETS

FEBRUARY 7, 2002

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ANALYSIS OF THE FAILURE OF SUPERIOR BANK, FSB, HINSDALE, ILLINOIS

THURSDAY, FEBRUARY 7, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:40 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

First of all, I want to thank our witnesses for their patience. We obviously have no control over this situation.

The vote was supposed to be at 5 minutes after 10 a.m. So, I thought we will begin the hearing after the vote, which seemed to make the most sense. The vote then got delayed somewhat, so it is a little later than would otherwise have been the case. But I do think we now have an uninterrupted period ahead of us. So, I think we will be able to carry this hearing through to completion. I certainly hope so.

This morning, the Committee holds another hearing on the failure of Superior Bank, an insured depository institution. We are very pleased to have as our witnesses this morning: Jeffrey Rush, Jr., the Inspector General of the U.S. Department of the Treasury; Gaston Gianni, Jr., Inspector General of the Federal Deposit Insurance Corporation; and Thomas McCool, the Managing Director for Financial Markets and Community Investments of the General Accounting Office, GAO.

Our witnesses will present their respective analyses of the causes of Superior's failure and offer their recommendations for preventing similar occurrences in the future.

The Committee completed its first hearing on the failure of Superior on October 16. Actually, it was scheduled for the morning of September 11 and, in fact, began that morning, I, operating on the premise that we were not going to let the terrorists close down the Government of the United States. Twenty minutes later, the Capitol police showed up and threw us out of the hearing room and said, you would better get out of the Capitol complex.

At the resumed hearing on October 16, we received testimony from the regulators, Ellen Seidman, Director of the Office of Thrift Supervision, and John Reich, Board Member of the FDIC, and also from three private-sector financial experts: Bert Ely, Professor George Kaufman, and Karen Shaw Petrou.

On July 27, last summer, the OTS closed Superior Bank after finding that the bank was critically undercapitalized. The OTS concluded that Superior's problems arose from, "a high-risk business strategy, and that Superior became critically undercapitalized largely due to incorrect accounting treatment and aggressive assumptions for valuing residual assets."

Superior is the largest U.S.-insured depository institution by asset size to fail in more than 9 years. The FDIC estimates that Superior's failure will result in a loss to the Savings Association Insurance Fund of approximately $300 to $350 million. That is, as I understand it, their latest estimate.

Since our last hearing, there have been a number of significant developments and I want to take a moment to touch on those.

First, regulatory developments have addressed two issues that were raised at that hearing. On November 29 of last year, the Federal bank regulators jointly announced the publication of a final rule that changes the regulatory capital standards to address the treatment of recourse obligations, residual interests, and direct credit substitutes that expose banks, bank-holding companies, and thrifts to credit risks. This new rule addresses the question of large holdings of risky residual assets as arose in Superior's case. On January 29 of this year, the FDIC announced an agreement among the Federal bank regulators that expands the FDIC's examination authority. It makes it easier for the FDIC to examine insured banks and thrifts about which it has concerns. This addresses situations in which the FDIC wants to come in and participate in an examination, but the primary regulator refuses.

Second, on December 10, the FDIC and OTS reached a $460 million settlement agreement with Superior's holding companies and their owners.

Third, with respect to the resolution, the FDIC as conservator has operated the bank. On November 19, Charter One Bank bought Superior's deposit franchise and other assets for a premium of about $52. The FDIC is currently in the process of selling the bank's remaining assets.

The focus of today's hearings will be the findings and recommendations of the Treasury, the FDIC, and the GAO. In requesting these three agencies in the wake of Superior's failure to assess the reasons why the failure of Superior resulted in such a significant loss to the deposit insurance fund, I specified a number of areas of analysis, including the timeliness of regulatory response, the role of the outside independent auditor, and the issue of coordination among the regulators.

We also requested in our letters to the three witnesses before us, or their agencies, recommendations for preventing future bank failures with their attendant losses. Their recommendations take on a new urgency as depository institutions continue to fail, not only at a cost to the insurance fund, but also to public confidence in our banking system, which, of course, is an intensifying problem nowadays, given all of what has transpired.

Since the failure of Superior Bank just 7 months ago, four other insured banks have failed, with a potential cost to the BIF of somewhere, it is estimated, between $250 and $450 million. So this hearing comes at a timely moment. These reports have just been

completed and are ready now for, as it were, public attention, and that is why we moved quickly to try to hold this hearing at this opportune time.

We look forward to hearing from our witnesses. Mr. Rush, we will start with you and just move right across the panel.

STATEMENT OF JEFFREY RUSH, JR.
INSPECTOR GENERAL, U.S. DEPARTMENT OF THE TREASURY

Mr. RUSH. Thank you, Mr. Chairman. I am delighted to appear before the Committee to discuss our review of Superior.

I would like to take one brief moment to introduce Marla Freedman, Don Kassel, and Benny Lee, the three audit professionals who not only run my entire audit program, but were responsible for all the banking work that we do at Treasury. They are seated behind me.

Chairman SARBANES. Why don't they stand up, so that we can acknowledge them.

Good. Thank you all very much.

Mr. RUSH. We appreciate that. As you know, Superior was supervised by the Office of Thrift Supervision, an agency of the Department of Treasury. Under the provisions of the Home Owners' Loan Act, OTS is responsible for chartering, examining, supervising, and regulating Federal savings associations and Federal savings banks.

The Federal Deposit Insurance Corporation Improvement Act of 1991 mandates that the inspector general of the appropriate Federal banking agency shall make a written report to that agency whenever the deposit insurance fund incurs a material loss. A loss is deemed material if it exceeds the greater of $25 million or 2 percent of the institution's total assets at the time that the FDIC initiates assistance or is appointed as a receiver. We have completed that review and on February 6, just yesterday, as mandated by FDICIA, my office issued a report on the material loss to the Director of the OTS and to the Chairman of the FDIC and the Comptroller General of the United States.

I have prepared a statement and I will highlight some of the causes of Superior's failure, our concerns about the supervision of OTS, including the use of Prompt Corrective Action, and a status report on both ongoing audit and investigative work that our office is engaged in, all related to Superior's failure.

As you have already stated, Superior's failure is the largest and most costly thrift failure since 1992. The FDIC has estimated the failure to exceed $300 million. At the time of its closing in July 2001, Superior had just over $1.9 billion in booked assets, which were largely funded with FDIC-insured deposits, totalling almost $1.5 billion.

Superior was formerly known as Lyon Savings Bank of Countryside, Illinois and was acquired for $42½ million. Beginning in 1993, Superior embarked on a business strategy of significant growth into subprime home mortgages and auto loans. Superior transferred the loans to a third party, who then sold asset-backed securities to investors. The repayment of these securities was supported by the expected proceeds of the underlying loans.

The large, noncash earnings generated from the subprime loan securitizations masked actual losses from flawed residual asset

valuation assumptions and calculations. Superior's true operating results did not become evident to OTS or FDIC until October 2000, when they discovered that inaccurate accounting practices and faulty valuation practices had been going on.

The root causes of Superior's failure go back to 1993. Indeed, we believe Superior exhibited many of the same red flags and indicators reminiscent of problem thrifts of the 1980's and 1990's. These include: one, rapid growth into a new, high-risk activity, resulting in an extreme asset concentration; two, deficient risk-management systems related to valuation issues; three, liberal underwriting of subprime loans; four, unreliable loan loss provisioning; fifth, economic factors that affect asset value; and six, nonresponsive management to supervisory concerns.

In the early years, the OTS's examination and supervision of Superior appeared inconsistent with the institution's increased risk profile. It was not until 2000 that the OTS expanded examination coverage to residual assets and started meaningful enforcement actions. By then, it was, arguably, too late, given Superior's high level and concentration of residual assets.

We believe that OTS's supervisory weaknesses were rooted in a set of tenuous assumptions regarding Superior. Despite OTS's own increasing supervisory concerns, OTS: one, assumed the owners would never allow the bank to fail; two, assumed that Superior's management was qualified to safely manage a complex and high-risk program of asset securitization; and three, that the external auditors could be relied upon to attest to Superior's residual asset valuations. All of these assumptions proved to be false.

OTS did not actively pursue an enforcement action to limit Superior's residual asset growth with a Part 570 safety and soundness compliance plan until July 2000. One of the Part 570 provisions required Superior to reduce residual assets to no greater than 100 percent of core capital within a year.

I should note that at this time, the residual assets were then about 350 percent of tangible capital. Although grounds existed for more forceful enforcement actions.

Chairman SARBANES. When you say, at this time, when was that?

Mr. RUSH. In late 2000. This is the summer of 2000.

Although grounds existed for a more forceful enforcement action, such as a temporary cease-and-desist order, two OTS supervisory officials chose the Part 570 notice because it was not subject to public disclosure, whereas, other actions were subject to public disclosure. The OTS felt that public disclosure of an enforcement action might impair Superior's ability to obtain needed financing through loan sales.

Throughout our report and in my statement, I will give you specific examples of weaknesses associated to OTS's examination of Superior. But given the amount of time, I would like to just go to our nine recommendations and then conclude by giving you a status report on the ongoing work.

Chairman SARBANES. Fine. The whole report will be included in the record and we are going to work through it very carefully as we develop an action program. But please go ahead.

Mr. RUSH. Our first recommendation is that OTS issue additional guidance with respect to third-party service providers. As you know in this case, Superior relied upon a third-party firm called Fintek to do those valuations for them.

Our second recommendation is that OTS should assess the adequacy of guidance with respect to the examination of thrifts whose critical functions are geographically dispersed. This, again, was a problem with Superior in that it had offices not only in Illinois, but relied upon a New York firm to provide valuations.

Recommendation three—we are asking OTS to require quality assurance reviews to cover examinations where an expanded review of the external auditor's workpapers would have been warranted. You will note that we found that only after 2000 and 2001, did OTS look beyond the valuations that were attested to by the outside auditor.

Recommendation four—we are asking OTS to assess the adequacy of guidance with respect to the application of new and changing accounting standards. It is clear that during this period of time in the middle 1990's, there was some confusion as to how the accounting standards applied to valuing securitized assets.

Recommendation five—we are asking OTS to establish minimum testing procedures and assess the adequacy of guidance with respect to valuation policies and practices relating to residual assets.

Recommendation six—we are asking OTS to ensure that quality assurance reviews cover adequacy of examiner follow-up on previously reported problems. We found substantial evidence that examiners failed to take action a second and third time when they returned to Superior and not found corrective action being taken.

Recommendation seven—we are asking OTS to determine whether Superior violated Prompt Corrective Action restrictions when senior executives were paid bonuses in 2001.

Recommendation eight—we are asking OTS to assess the adequacy of existing supervisory controls used to ensure thrift compliance with PCA restrictions as a general proposition.

And finally, we are asking OTS to assess whether legislative or regulatory changes to PCA are warranted.

As you will note in both my statement and the report, the concern about PCA is as follows. PCA activities tend to follow examination and discovery of capital problems. Thus, by looking at a lagging indicator, it is often too late for PCA to accomplish precisely what we think the legislation intended.

Let me close by giving you a brief summary of our current activities. First, with respect to our audit. As you will note in our audit report, we do identify a scope limitation. We were unable to fully assess the aspects of OTS's supervision of Superior. This was due to the delays in getting access to a substantial number of records that were received in late 2001.

As you may know, OTS issued 24 subpoenas in July and we did not get access to that material until almost November. We are going to continue our audit work to review all of that material and we will issue a separate report on all the material that we find. And we will also develop any leads necessary based upon that examination of records.

In addition to our audit work, we are working closely with my colleagues in FDIC and with the Department of Justice through the Northern District of Illinois, where the U.S. Attorney in Chicago has asked us to look into a series of issues related to the bank failure to determine if there were any violations of law. We will issue a report on that investigation, as will our colleagues, at an appropriate time.

That concludes my oral statement.

Chairman SARBANES. Well, we look forward to receiving that report. Do you have any idea of the timeframe for that?

Mr. RUSH. We are in the initial stages of interviewing employees of Superior. FDIC and Treasury investigators were in New York 2 weeks ago. We have a lot of work to do jointly with the FDIC down in Texas and we will probably be spending the next few months sorting through the documents received through subpoenas.

These subpoenas reach not only into the holding company, the firm, and its affiliates, but to some 15 individuals and to the external auditor.

From my own standpoint, my office is particularly concerned that we have not looked at the external auditor's work papers. We have only looked at the work done by the external auditor to the extent that their work was included in the examination files that we looked at.

So, we are talking conservatively a period of months.

Chairman SARBANES. All right.

Mr. Gianni.

STATEMENT OF GASTON L. GIANNI, JR., INSPECTOR GENERAL FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GIANNI. Thank you, Mr. Chairman.

May I take the liberty to introduce my audit team also that have been poring over this?

Chairman SARBANES. Well, you better. Otherwise, you are going to have a morale problem.

[Laughter.]

Mr. GIANNI. Mr. Chairman. To my left is Rus Rau, who is head of my audit organization. To my right is Patricia Black, my counsel. In back of Patricia is Steve Beard, who is one of my executives working on this job, and Mike Lombardi and David Loewenstein, who is my Congressional person.

Chairman SARBANES. Why not ask them to stand? We very much appreciate their efforts in this regard.

Mr. GIANNI. I will be able to go back to work now.

[Laughter.]

Thank you, sir. For purposes of our testimony, our responses to the nine topics you raised are summarized in four questions: Why did this bank fail? What was the role of the principal auditor? What did the regulators do? And why has this failure resulted in such a large loss of deposit insurance? We will also provide you and the Committee with the status of FDIC's resolution activities on the failed bank.

I am going to try to, because we were covering some of the same ground that my colleague, the Inspector General from Treasury, I

am going to try not to repeat some of the common themes. But what I would like to do is focus on why the bank failed and just give you an overview, without going into the specific details, since you have said that the report and testimony will be put in its entirety in the record.

The failure of Superior was directly attributable to the bank's board of directors and executives ignoring sound risk management principles. They permitted excessive concentrations in residuals resulting from subprime lending rather than diversifying risk, and did so without adequate financial resources to absorb potential losses. They supported flawed valuations and accounting for residual assets that resulted in recognition of unsubstantiated and unreasonable gains from securitizations. They paid dividends and other financial benefits without regard to the deteriorating financial and operating conditions of Superior. And they overlooked a wide range of accounting and management deficiencies.

These risks went effectively unchallenged by the principal auditor. The firm issued unqualified audit opinions each year, starting in 1990 through June 30, 2000, despite mounting concerns expressed by the Federal regulator. As a result, the true financial position and results of operations of Superior were overstated for many years.

Once the residual assets were appropriately valued and generally accepted accounting principles were correctly applied, Superior was deemed to be insolvent by the OTS and OTS appointed the FDIC as receiver. At that time, the estimate of the loss was between $426 and $526 million.

At Superior, the board of directors did not adequately monitor on-site management and overall bank operations. Numerous recommendations contained in various OTS examination reports beginning in 1993 were not addressed by the board of directors or the executive management. These recommendations included: placing limits on residual assets; establishing a dividend policy that reflects the possibility that estimated gains may not materialize; correcting capital calculations; writing down the value of various assets; and, correcting erroneous data contained in the thrift financial reports to OTS.

I would like to turn to the role of the principal auditor. Ernst & Young, the bank's external auditor from 1990 to 2000, gave Superior, as I said, unqualified opinions. In 1999, Ernst & Young did not question the actions of Superior when it relaxed underwriting standards for making mortgage loans and also used more optimistic assumptions in valuing the residual assets. In 2000, when the examiners from both the OTS and FDIC started questioning the valuation of these assets, Ernst & Young steadfastly maintained that residual assets were being properly valued at the bank.

Our work indicated that Ernst & Young also did not expand sufficiently its 2000 audit after the OTS and FDIC questioned the valuations of Superior's residual assets in January 2000. They did not ensure that Superior made adjustments to the capital required by OTS as part of the 2000 audit. They did not disclose, as a qualification to what was instead an unqualified opinion in 2000, that Superior may not have been able to continue as an ongoing concern because of its weak capital position as reflected in poor composite

ratings by the Federal regulators. And last, they did not perform a documented independent valuation of Superior's residual assets as part of its annual audit, but instead, only reviewed Superior's valuation methodology and did not perform sufficient testing on securitization transactions.

The OTS concluded the June 2000 financial statements were not fairly stated, contrary to the auditor's opinion. OTS recommended to the board of directors that the opinion should be rejected and the financial statements restated.

Now, I wish to turn to the regulators. Banking and thrift regulators must also ensure that accounting principles used by financial institutions adequately reflect prudent and realistic measurements of assets. The FDIC, as insurer, must coordinate with the primary Federal regulators who conduct examinations of the institutions. In addition, the Congress has enacted legislation addressing Prompt Corrective Action standards when financial institutions fail to maintain adequate capital. These processes were not fully effective with respect to Superior.

While OTS examination reports identified many of the bank's problems early on, they did not adequately follow-up and investigate the problems, particularly residual assets, as Mr. Rush has identified. These issues include placing limits on residual assets, establishing a dividend policy with consideration given to the imputed but unrealized gains from residual assets, errors in the calculation of allowance and loan lease losses, and the thrift financial reporting errors.

Coordination between the regulators could have been better. The OTS did deny FDIC's request to participate in the regularly scheduled safety and soundness exam in January 1999, delaying any FDIC examiner on-site presence for approximately one year. FDIC has special exam authority under 10(b) of the Federal Deposit Insurance Act to make special examination of any insured deposit institution. An earlier FDIC presence at the bank may have helped to reduce losses that will ultimately be incurred by the SAIF. FDIC examiners were concerned over the residual asset valuations in December 1998. However, when the OTS refused an FDIC request for special examination, FDIC did not pursue the matter with its board. Working hand-in-hand in the 2000 examination, regulators were able to uncover numerous problems.

As I said, Prompt Corrective Action did not work in this case. Under PCA, regulators may take increasingly severe supervisory actions when an institution's financial conditions deteriorate. The overall purpose of PCA is to resolve the problem of insured depository institutions before capital is fully depleted and thus limit the losses to the fund. For those institutions that do not meet minimum capital standards, regulators may impose restrictions on dividend payments, limit management fees, curb asset growth, and restrict activities that pose excessive risk to the institution. None of this occurred at Superior until it was too late to be effective.

The failure of Superior underscores one of the most difficult challenges facing bank regulators today—how to limit risk assumed by banks when their profits and capital ratios make them appear financially strong. Risk-focused examinations adopted by all the agencies have attempted to solve this challenge. However, the re-

cent failures of Superior Bank, First National Bank of Keystone, and BestBank demonstrate the need for further actions.

In addition, beginning with the January 2000 exam, we believe that the OTS used a methodology to compute Superior's capital that artificially increased capital ratios, thus avoiding imposition of PCA. OTS used a post-tax capital ratio to classify Superior as "adequately capitalized." Thus, Prompt Corrective Action did not kick in. If a pretax calculation had been used, Superior would have been undercapitalized and more immediately subjected to various operating constraints under PCA. These constraints may have precluded Superior management from taking actions in late 2000 that were detrimental to the financial institution.

Let us look at the loss to the fund. As of January 2001, as you stated, FDIC estimates the loss will range between $300 and $350 million. This loss includes the present value of the settlement in the amount of $460 million with the principal owners of the bank that was entered into by FDIC. Under the agreement, an affiliate of the bank's former holding company paid $100 million up front and plans to make an additional $360 million over a 15 year period. If these payments are not made, the losses will be substantially increased.

The FDIC board of directors determined that a conservatorship would be the least cost alternative for the Savings Association Insurance Fund. This decision was made, in part, because FDIC did not have sufficient information to develop other possible resolution alternatives. FDIC's access to Superior was limited, partly based on the fact that Superior's owners were in the process of implementing OTS's approved capital plan. When it did not materialize, FDIC had one day to close the bank and move into a conservatorship. Consequently, complete information on the range of resolution alternatives was not available to the FDIC to make the least cost decision for Superior's resolution. Since the bank has failed, FDIC has made progress, as you stated in your opening statement, in disposing of assets and certainly selling the deposits of the bank to another institution at a premium.

There is now a new rule to amend the regulatory capital treatment of residual assets. In November, the Federal bank and thrift regulatory agencies issued the rule. We believe that if Superior had operated in accordance with these rules, if they were in effect at the time—they were not, but if they were—it would not have incurred the losses that it did and may have avoided a failure. I just cannot predict that, but it is possible.

Our recommendations are broad, but we have identified a number for regulatory oversight agencies to consider. First, reviewing the external auditor's working papers of institutions that operate high-risk programs such as subprime lending and securitization. Second, following up on red flags that indicate possible errors or irregularities.

I might just as an aside, based on the work that we did in the failed bank and the work that my colleague did on the failed Keystone Bank and the investigation, we have developed a number of red flags and have put together a training program that we are offering to the FDIC bank examiners. We have also offered this training to the OTS and to the Office of the Comptroller of the Cur-

rency, making it available to their examiners. We are trying to share this knowledge that we have gained about what types of red flags are occurring in these institutions and how the examiners might be alert when these red flags crop up in their exams.

Third, consult with other regulatory agencies when they encounter complex assets, such as those in Superior. I think it is good that they work in collaboration and that there is a joint governmental expertise brought to the situation. Last, follow up on previous examination findings and recommendations to ensure bank management has addressed examiners' concerns.

In a related audit report that we will be releasing in the near future, we are recommending that FDIC take actions to further strengthen its special exam authority. As you indicated last week, the board did grant additional authority to FDIC to access banks with CAMELS composite ratings of "3", "4", "5" as well as any that are undercapitalized. In addition, they have created an opportunity for FDIC to have access to the eight largest institutions, so that the examiners from FDIC can begin to build up additional expertise and real time understanding of any issues that these larger institutions may face. This expanded delegation implements the interagency agreement outlining the circumstances under which FDIC will conduct the examinations of institutions not directly supervised by the FDIC.

While the agreement represents great progress for interagency examination coordination, it still places limits on FDIC's access as insurer. Had the provisions of this agreement been in effect in the 1990's, it would not have ensured that the FDIC could have gained access to Superior without going to its board when it requested access in December 1998. At that time, the bank was 1-rated from its previous OTS examination and there were disagreements as to whether there was sufficient evidence of material deteriorating conditions. To guarantee the FDIC independence as the insurer, we believe that the statutory authority for the FDIC's special exam authority should be vested in the FDIC Chairman. And if he would use that type of statutory authority, he would do so consulting with the other regulatory agencies. But it vests authority with the person who is responsible for overseeing the insurance fund.

Last, we will be recommending that FDIC take the initiative in working with other regulators to develop a uniform method of calculating the relevant capital ratios used to determine an insured depository institution's Prompt Corrective Action category.

In summary, the ability of any bank to operate in the United States is a privilege. This privilege carries with it certain fundamental requirements—accurate records and financial reporting on an institution's operations, activities, and transactions, adequate internal controls for assessing risks and compliance with laws and regulations, as well as utmost credibility of the institution's management and its external auditors. Most of these requirements were missing in Superior Bank. A failure to comply with the reporting requirements, poor internal controls, a continuing pattern of disregard for regulatory authorities, flawed and nonconforming accounting methodology, and the potential for the continuation of unsafe and unsound practices left regulators with nothing else to do but close Superior.

Superior and the resulting scrutiny it has received will hopefully provide lessons learned on the roles played by bank management, external auditors, and the regulators, so that we may better avoid problems through improved communication, methodologies, and policies, the events that led to the institution's failure.

Thank you, Mr. Chairman. I would be happy to answer your questions.

Chairman SARBANES. Thank you very much.

Mr. McCool.

STATEMENT OF THOMAS J. McCOOL, MANAGING DIRECTOR FINANCIAL MARKETS AND COMMUNITY INVESTMENT U.S. GENERAL ACCOUNTING OFFICE

Mr. MCCOOL. Mr. Chairman, I guess the trend has been set, so I also probably feel obliged to recognize the audit team that actually did all the work. I am just a figurehead here.

Chairman SARBANES. It is not obliged. I understood you insisted upon that opportunity before we ever began here today.

[Laughter.]

Mr. MCCOOL. We have Jeanette Frenzel and Darryl Chang, who are from our accounting group, Harry Medina, Karen Tremba, Kristi Peterson, who are from our financial markets group, and Paul Thompson from our Office of General Counsel.

Chairman SARBANES. Good. Why not ask them to stand and we express our appreciation to them for the hard work that we know has been done.

Good. We would be happy to hear from you, Mr. McCool.

Mr. MCCOOL. Mr. Chairman, we are pleased to be here today to discuss our analysis of the failure of Superior Federal Savings Bank. Clearly, the size as well as the suddenness of its failure raised questions about what went wrong and what steps can be taken to reduce the likelihood of such costly failures in the future.

My testimony today will briefly discuss the causes of Superior's failure and will evaluate the effectiveness of Federal supervision. We will also discuss some of the broader supervisory issues that were raised by the Superior failure and other recent failures.

The primary responsibility for the failure of Superior has to reside with the owners and managers. Superior's business strategy of originating and securitizing subprime loans appeared to lead to high earnings, but, more importantly, resulted in a high concentration of extremely risky assets. This concentration and the improper valuation of these assets ultimately lead to Superior's failure.

Originating and securitizing subprime home mortgages and auto loans are not inherently unsafe and unsound practices, but both require accurate measurement of the risks and vigorous management oversight. This is especially true when trying to make securitization attractive to the market, the originating bank retains the riskiest parts. The valuation of these residual interests is a very complex process and is highly dependent upon assumptions about future defaults, interest rates, and prepayment rates. Superior's residual interests were improperly valued and when these valuations were adjusted, the bank was recognized as significantly undercapitalized and eventually failed.

Moving on to the quality of oversight provided by the regulators. Although we focus on three major areas of concern with OTS's supervision of Superior, the bottom line is that we do not believe that OTS exercised sufficient professional skepticism.

First, its supervision appeared to be heavily influenced by the apparent high earnings and capital levels. Throughout the middle to late 1990's, OTS noted that Superior's activities were riskier than most other thrifts and merited close monitoring, but these reports also balanced those concerns with discussions of higher than peer earnings and leverage capital ratios. This was true even though the earnings represented estimated and uncertain payments in the future and the magnitude was based on the riskiness of the underlying business strategy.

Second, OTS consistently assumed that Superior's management had the necessary expertise to safely manage the risky activities and relied on Superior's management to take necessary corrective actions to address deficiencies noted in examinations. Moreover, OTS counted on the owners coming to the financial rescue of Superior, if necessary. As my colleagues have already stated, all of these assumptions proved unfounded.

Third, OTS also placed undue reliance on the external auditor. The GAO has always supported having examiners use the work of external auditors to enhance supervision and minimize burden. However, this reliance needs to be predicated on the examiners obtaining reasonable assurance that audits have been performed in a quality manner.

In the case of Superior, Ernst & Young provided unqualified opinions on the bank's financial statements for years. Only at the insistence of the regulators did Ernst & Young's regional office seek a review by the national office on the valuation question and the national office decided that the regulators were correct. But the problems were so severe, that failure was inevitable.

FDIC, on the other hand, raised questions, serious questions about Superior's operations at the end of 1998, based on its off-site monitoring and asked that an FDIC examiner participate in the January 1999 exam, although earlier FDIC off-site reviews had not raised any concerns. FDIC's 1998 off-site review noted with alarm the high-risk asset structure and the residuals were 150 percent of capital. It also noted significant reporting differences between the bank's audit report and its regulatory financial report.

As again was stated earlier, the OTS and the FDIC coordination was hindered by poor communication regarding supervisory concerns and strategies. The policy existing at the time stated that the FDIC participation was based on anticipated benefit to the FDIC as the deposit insurer and risk of failure that the institution poses to the fund.

Again, part of our concern in this case was that it is not clear that the FDIC nor OTS actually followed the procedure and policy that was in place. We do know that OTS eventually did not allow FDIC to join in the examination in 1999, but it did allow a review of work papers.

On this basis, OTS lowered the rating of Superior from a "2" to a "3". We do know the new policy is in place and again, one of our concerns was that the old policy was not implemented, so the new

policy, to be effective, at least has to be implemented. If not, as Mr. Gianni has already said, more presumption needs to be placed on FDIC's ability to get into an institution, no matter what its rating might be.

As a consequence of the delayed recognition of problems at Superior Bank, enforcement actions were not successful in containing the loss to the insurance fund. Once the problems were identified, OTS took a number of formal enforcement actions, including a PCA directive.

Although it is impossible to know if early detection would have prevented the failure of Superior, it is likely that earlier detection could have triggered enforcement actions to limit Superior's growth and asset concentration and, as a result, the size of the loss to the insurance fund.

Now, I would just like to conclude with a few observations.

I guess the issue of Prompt Corrective Action is always an interesting one. Obviously, the current Prompt Corrective Action tripwires are based on measures in capital. One of the issues I think that has already been suggested is that the new regulation on residuals and capital treatment for residuals would have potentially at least mitigated, if not resolved, the problem at Superior. And so the fact is that the regulators have taken action to improve their risk-based capital treatment for residual assets.

I guess it is also true that the regulators are involved in a much higher level and broader attempt to try to improve the risk-based capital measurement, and again, that should also go some way toward improving the usefulness of Prompt Corrective Action if it is based on risk-based capital measures that more properly measure risk than the current risk-based capital measures.

Another observation is that, currently, the final tripwire that pushes banks and thrifts into the critically undercapitalized category is based on a leverage ratio. So all the tripwires before that are based on measures of risk-based capital. But the final tripwire is currently a leverage ratio.

We think that is something that the regulators ought to revisit, that if risk-based capital is well founded, that you would also want to potentially move a firm or a bank into critically undercapitalized category based on a risk-based capital measure as well.

And then the last observation, which is an observation that we have been making for a long time, is that, again, as has been mentioned numerous times so far, capital is a lagging indicator and any tripwires based on capital are always going to be probably too slow to keep the Bank Insurance Fund from taking some kind of a hit. It could be less in various circumstances, but it is still going to be difficult to keep the insurance fund from taking some losses.

But we do think that noncapital tripwires, tripwires that are based on either management or operationally based safety and soundness measures, again, some of the red flags that have also been discussed earlier, would be and could be used more effectively by the regulators than they currently are, that these red flags should trigger at least much more intensive oversight by the regulators and potentially could even lead to a presumption that enforcement actions would result if certain tripwires, certain red flags were set off.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions.

Chairman SARBANES. Well, thank you very much. We appreciate the testimony of the the members of the panel.

I just want to show a chart to start here. These are the amount of residuals held by the 10 largest holders of residual interest. Now this was as of March 2001, so it is pretty late in the process, and I am going to deal with that in a minute. That is Superior over at the left.

[Laughter.]

You might tend to miss it because you tend to see everyone down here, and there, it looms over there.

[Laughter.]

Now, a year earlier, the residuals as a percent of their Tier 1 capital went up by about 25 percent between January 2000 and January 2001. So even if I start adjusting that column and take it down a little bit, the gap is still enormous.

How can anyone looking at something like that fail to say, well, there is really something strange going on here? Either Superior are geniuses that no one else in the whole industry has perceived, or there is something amiss here. And it seems to me, given those two choices, you would tend to conclude that something is amiss because there are a lot of smart people in these businesses.

And that leads me to this question about where you all said that the OTS examiners expressed concern about the residual assets going back some number of years. But they continued to grow.

Why was nothing done? They were recommending corrections, but they did not require corrections and they just let it go from year to year and that column continued to run up. This gap or this contrast just grew and grew and we had this very serious problem.

In the meantime, of course, they were over-valuing these residuals. They were paying out very significant dividends over that period of time, in the hundreds of millions, if I am not mistaken. Now how did it just drift like that? Why didn't the OTS examiners move from just noting it and recommending to requiring? Do we have any perceptions on that point?

Mr. RUSH. I will speak first. We have all mentioned the set of assumptions that we found when we went into examination records and talked with regulatory officials. And two of those assumptions I think bear upon the question you are raising.

It would appear that OTS examiners thought that management at Superior knew what it was doing during these periods of rapid growth. And it is clear now that they did not.

Chairman SARBANES. It is a little bit like Enron, isn't it?

Mr. RUSH. Yes.

[Laughter.]

It is also clear that because the owners are known for their personal wealth, the two principal investors, there seemed to be a sense within OTS that because this was one of those rescued institutions of the late 1980's, that the investors would be willing to bring additional capital to the table.

Let me be sure, though, that your point is not lost on that chart. Your chart only shows probably a half dozen institutions and it

starkly contrasts the residual assets at Superior Bank from other institutions.

I indicated in my statement and in greater detail in our audit report, the value of residual assets on the books at Superior Bank exceeded that of the next 29 thrifts in the United States. It is clearly something that was known and apparent to the regulators.

Chairman SARBANES. Yes, it just loomed out of the landscape.

Mr. RUSH. But we really cannot account for this failure to act when you see such incredible growth over a short period of time.

Chairman SARBANES. Does anyone else want to add anything?

Mr. GIANNI. What you are talking about is a system where recommendations are made and in subsequent recommendations or subsequent years, you have a follow-up system to ensure that those recommendations were addressed. What OTS advised us was that it fell through the cracks. From 1993 to 2000, where you have management not paying attention, and the board not paying attention to what the regulators are saying. In my opinion, that is a strong indictment of that management and the board.

Why OTS did not push harder? I cannot answer that question, sir. I can speculate. It is a matter of whether it is being brought up the chain of command. It is how far the examiners are bringing it up the chain of command, what degree of support they feel they are going to get from the chain of command.

This is a difficult situation where you have regulators trying to regulate, and at the same time they are dependent on those institutions for their livelihood. It is a fine line that has to be walked. And I do not know that that would be the case here, but it is a difficult environment that the examiners are operating in.

Chairman SARBANES. Mr. McCool in his testimony says, "The failure of Superior Bank illustrates the possible consequences when banking supervisors do not recognize that a bank has a particularly complex and risky portfolio."

Now at our first hearing here, Professor Kaufman made a recommendation, "Establish an interagency SWAT team for valuing complex assets. This would likely be of particular benefit to the OTS and FDIC who deal primarily with smaller and less complex institutions."

What is your view of a SWAT team or a group with specialized expertise available to all bank regulators? Is that feasible? Would that be useful? What is your reaction to that?

Mr. GIANNI. My reaction is very positive. In fact, I think that my new chairman would be receptive to that type of engagement, where the regulators come together and work. We certainly would be pushing for it as the insurer. We would like to see more opportunities where our examiners are working side by side with the principal examiners. I think it makes for good Government.

Mr. MCCOOL. If I might add.

Chairman SARBANES. Yes.

Mr. MCCOOL. I think that there is a number of different areas in which the regulators can internally or externally provide expertise. I think some of the agencies have a fair amount of expertise already. For others, a SWAT team might be a very useful device.

I guess the one thing that I would also suggest, though, is that there is a dynamic within not just OTS, but to some extent, all the

regulators, of not necessarily wanting to go out to someone else and ask for help. And so, I think part of it is that—I know that this happens in my work at GAO. It is an idea that you think you can bring to bear the right resources and it is somehow, to some extent, admitting that you do not know how to do your job if you have to go out and ask for help.

This is something that would have to be worked from an internal dynamic, internal cultural perspective, that it is not only all right, but it is expected that examiners or the relevant parties know what they do not know and know where to go to get help. That would be an important part of making something like this work.

Chairman SARBANES. Mr. Rush, did you want to add to that?

Mr. RUSH. I come at it a little differently without being troubled by the approach.

There is a tendency to invest expertise in people who can provide it too late. And my best example would be arson investigators, the people who know the most about fires, only come on the scene when the building's been destroyed.

Chairman SARBANES. Right.

Mr. RUSH. I think the concern I would have about a SWAT team approach is being certain you integrate it into the routine processes of examinations, rather than assume that people who do not know what they do not know, are going to ask for help.

I will again go back to your chart. None of us are paid as examiners. All of us can see the stark difference in the valuation of residual capital held by Superior and other institutions. Yet, no one took action even under the best of circumstances until late 1998, early 1999. From the standpoint of effective action, it was too late. If we have a SWAT team that comes in after we have a failed bank, we have just added one more layer of ineffective regulation.

So, I would certainly hope that any consideration for a SWAT team approach that does ensure expertise assumes that you have to integrate it in the regulatory process on the front end and not on the tail end.

Chairman SARBANES. Well, maybe you could require the particular regulators to certify a certain number of cases for the SWAT team each year.

Mr. RUSH. This is the position that I assume we could all agree.

Chairman SARBANES. Which would get at your point. So, then, part of the job of the ordinary inspectors is to locate at least whatever number of cases you are talking about that have to go over for further examination by the SWAT team, which could be a composite from the various agencies and would be a highly trained, highly skilled group. Of course, its arrival on the scene would, in and of itself, send an important message.

Mr. RUSH. Signal. Oh, yes.

Chairman SARBANES. Presumably. The *American Banker* on February 5, wrote an article entitled, "OMB—More Failures, New FDIC Premiums." And it reported: "The Office of Management and Budget is predicting a sharp and sustained increase in spending on bank failures over the next 6 years."

And then they made reference to these other failures that I talked about. What are your views as to whether the regulators have adequate staff and experience to meet the coming challenges?

And I do not want to set you up, Mr. Gianni. I understand the FDIC is planning to RIF a sizable number of attorneys. I do not know how I square that with this OMB prediction of additional failures and where we are going to be if we lose this? What is your perception of the adequacy of the resources that are available to the regulators to monitor these situations?

Mr. GIANNI. With regard to the lawyers, you are right that the Corporation is in the process of downsizing the amount of lawyers that they do have. Many of those lawyers were the residual from the 1990's, when we were cleaning up the failed bank institutions.

Chairman SARBANES. You use the word residual advisedly, I assume.

[Laughter.]

Mr. GIANNI. It seemed appropriate. I must have it on my mind. But, anyway, they are trying to get to a level that will allow them to effectively carry out their responsibilities. At the same point in time, the projections that OMB are putting forth would indicate that there may be a rise in failures. That would be certainly a large workload for resolution-type activities and not necessarily exam-type activities.

For the resolution activities, FDIC has moved to a different strategy. They have moved to a strategy to adopt a RTC approach, a Resolution Trust Corporation approach. FDIC calls it the firehouse approach, which basically says this is the level of resources we need for policy and oversight. But we are going to depend on the private sector to help us resolve the institutions by managing the assets, quantifying the assets, and then ultimately selling those assets. That was an RTC model, and in hindsight, it was a model that worked, although there were some blemishes. But RTC worked very effectively. So, we have adopted that.

As it relates to the examiners, FDIC has not undergone a reduction in its examination force. My biggest concern about our examination force is that the FDIC is the principal regulator for only one of the top 20 largest institiutions. There is a lot going on in these institutions with new instruments trying to advance the financial markets. If we, as insurers, do not have the expertise to deal with those issues, it presents a problem for us not only in the supervisory area, but also in the area of resolving those assets, should those institutions fail. So, I think the agreement reached by the board to allow FDIC to begin to participate in the exams of large institutions will help strengthen that expertise within the Corporation.

Chairman SARBANES. Anyone want to add to that?

Mr. RUSH. I found that article curious in that none of the regulators rely upon appropriated funds to carry out their mission. And while I do not doubt that within any of the agencies that are at issue here, the Board of Governors at the Fed, the Corporation or the OCC or the OTS over at Treasury, they are all struggling with trying to structure themselves in a way to get the most from the funds that they do use. This is not a tax or budget issue. And so, I frankly found the report of the OMB statement in the *American Banker* to be somewhat curious.

A more direct response to what we have found in our audit work at both OTS and OCC, there is some unevenness in expertise and

in capacity from office to office. But I certainly cannot say from our recent audit experience we are concerned about the capacity of the two regulators to do their jobs. They do not have people problems that we can easily perceive.

Chairman SARBANES. What is the GAO's view of that?

Mr. MCCOOL. I think that we have not actually examined the human capital capacity of the regulators recently, but GAO has taken the position across the Government that there are obviously human capital challenges, especially as the Baby Boom ages and the more experienced examiners may start to retire. The regulators are all aware of this and trying to plan for it, trying to do proper succession planning.

But from a capacity perspective, I think there would be the potential loss of experienced examiners in the future that could be something of concern. I do not know that they do not have sufficient resources currently, but they may be worried about replacing experienced people who may be retiring in the near future.

Chairman SARBANES. Well, now, you have been given—you, I am talking about the FDIC, but the other banking regulators—exceptions to the regular pay scales in order to be able to hold on to qualified and experienced people. Am I correct in that regard?

Mr. GIANNI. That is correct, Mr. Chairman. In addition, from a standpoint in the past, the FDIC, like the rest of the Government, has undergone a number of buy-outs, offered a number of buy-outs for its employees. Each time when they offered those buy-outs, the experts in the bank examination area were not able to participate in those buy-out programs.

We are constantly refreshing our examiner workforce every year. So, we are hiring to deal with any attrition. And I believe, over time, the examination cadre has remained relatively stable.

Chairman SARBANES. I only mention that because the budget submitted by the President, in effect, vitiates what was a package arrangement last year with respect to providing similar pay treatment for the Securities and Exchange Commission for losing expertise. And the effort was to enable them to do what bank regulators are doing in order to hold onto some of their people. That was enacted by the Congress as part of a package which repealed a number of fees that were leveled on the securities industry.

The securities industry, which was in favor of repealing the fees—to no one's surprise—was also supportive, as we moved the legislative package through, of this special pay treatment or comparable pay treatment for SEC employees as the bank regulators have. But the Director of OMB has shelved the comparable pay treatment for the SEC. So, it is a very interesting development.

My own view is that it has clearly contravened the spirit of the legislation, which had those things packaged together. Had anyone envisioned that there would be a repudiation of the spirit of the arrangement, then we should have thought of making the repeal of the fees contingent upon providing the pay treatment. So, we are quite upset about that and we are now examining ways to try to deal with it, and I think it is very unfair to the SEC.

Also, it has compounded their problems since employees at the SEC who were under a lot of stress because of the difference in any event, had their expectations significantly raised because they

thought this problem would be taken care of. And now the Director of OMB has in effect spurned them. So, I mention that as an aside.

I want to ask about this agreement that was reached in late January between the FDIC and other banking regulators to expand the authority of the FDIC to examine insured banks and thrifts. I think this is an important step.

Comptroller Hawke is quoted in the *American Banker* of January 30 as follows:

> Don Powell and I are both very close friends and long-time colleagues. We both felt that it was very worthwhile to embody this arrangement in a memorandum of understanding that would make clear for our successors what we think the relationships between the agencies ought to be.

Well, of course, you know it is possible that future FDIC chairmen and comptrollers may not have the same rapport. They might change the agreement and so forth. How do we address that issue? If we think this is not a desirable arrangement, how can we ensure that it will stay in place?

Mr. GIANNI. I will take the first lead on this. I do not question Mr. Hawke's characterization. I think that the new Chairman of the FDIC does bring, is bringing a sense of building the team and outreaching to the other regulators to try to work in a collaborative manner. I think as long as we have people of goodwill, the process will work.

However, what the board gives, the board can take and the board changes from time to time. And at one point in our history, when we only had three board members, the board took away backup examination authority from the FDIC. And repeatedly, in my semiannual reports to the Congress and to my agency, I am pushing that the full complement of the board be filled because it is only when we have a full complement of the board will the FDIC really have its true independence. That will put three board members principally with interests of the FDIC and then the Comptroller and the Director of OTS as rounding out the board. So, I think it is important that fifth position be filled and I think the way to fix it is through statute. Give that backup examination authority to the chairman and require the chairman to coordinate with his colleagues, or her colleagues, as the case might be.

Chairman SARBANES. Do either of the other panelists have any view on that issue?

Mr. RUSH. The only view, sir, is that I think you have to correct it by statute. There is no body of regulations that you could count on over time to give you the result that a statute can give you.

Chairman SARBANES. Do you agree with that, Mr. McCool?

Mr. MCCOOL. I would agree. The only caveat I would suggest is that, again, it is also hard to legislate cooperation.

Chairman SARBANES. Well, Mr. Gianni's proposal actually puts the authority in a specific place. He said there should be consultation. But he did not share the authority.

Mr. GIANNI. That is correct. It would rest with the Chairman.

Chairman SARBANES. Well, chairmen always like to hear that.

[Laughter.]

Mr. GIANNI. I might get an eraser.

[Laughter.]

Chairman SARBANES. After Keystone Bank failed in September 1999, that resulted in a loss of about $700 million to the fund. The Federal banking regulators in September 2000, a year later, promulgated a proposed rule to impose stricter capital rules and limit the concentration of residuals. The comment period for the proposed rule closed on December 26, 2000. Now Keystone failed in September 1999. September 2000, a year later, they promulgated a rule. The comment period for the proposed rule closed at the end of that year. And at our first hearing in October 2001, there was no final rule. We spent a good deal of time on that at that hearing. Finally, at the end of November 2001, the Federal bank regulators jointly announced the publication of a final rule.

Now, I have two questions. First of all, if you have any view of the substantive adequacy of the rule, how you perceive it substantively. And second, why it took so long to complete it. Do you have any insights into that process, particularly in light of the recognized risks that were posed by holding residuals. We had, it seems to me, a serious problem here on our hands and we took an inordinate amount of time to finally close to a rule. And this Committee certainly pushed it very hard at that hearing in October. And of course, finally, at the end of November, the agencies came up with a rule. I would be interested in your responses on those two questions.

Mr. GIANNI. I will jump into it. On the first part——

Chairman SARBANES. That comes from sitting in the middle, Mr. Gianni.

[Laughter.]

Mr. GIANNI. From the substantive standpoint, I think, as I said in my testimony, I think it is going to work. It does build in some greater assurances and greater protection. So, I think on the substantive basis, it moved in the right direction.

On the latter question, this was rulemaking by committee. This was a guidance that came out of the Federal Financial Institution Examination Council, FFIEC, and where the regulators are coming together to work together to try to formulate policies, regulations, and joint procedures. We are currently looking at the process, Mr. Rush, myself and the IG at the Federal Reserve are currently looking at how that process is working.

But what appeared to be happening was that, in the past, there was not a strong leadership from the top to move the agenda along. And what happens is that we left it at the staff level to work on these initiatives. And there was not that impetus and push from the top to get the job done. We are looking at how that process is working. Mr. Powell is now the Chairman of the FFIEC and has tasked people within the Corporation to bring some more accountability to the FFIEC process. We hope that he is successful. We are studying the process and we will come out with a joint report later this year.

Chairman SARBANES. Does anyone want to add anything to that?

Mr. MCCOOL. I would just suggest that, again, our view I think is that, from a substantive perspective, that the policy appears to make sense.

I think, as Gaston was suggesting, part of the issue is that you had, again, as you always do on these FFIEC issues, four regu-

lators who will come at things with a slightly different perspective. The other is that this was a very difficult thing to try to figure out. And we do not know, and we will find out, if there are any unintended consequences that come out of the rule that was written.

And this is part of what, again, only experience will teach us, whether they went too far, did not go far enough. The issue with financial products is that they are always changing, they are always evolving, and you come up with a set of rules that seems to fit. They may fit in some set of circumstances and not others that are closely but not exactly the same. So, I think that, again, part of it was that it was a hard problem—there were some issues there. I think, again, that the fact that the regulators often come at things from a different perspective also will cause a lot of these processes just to take time. But I also do agree that more leadership would also help to move things along better than they have been moving.

Chairman SARBANES. Well, this may be an arena in which Congressional oversight can play a role as well. I have always thought that there is too much of a tendency to define Congressional action in terms of actually passing a statute. And of course, that is often a very important part of establishing the right framework. But I think there is a very important role to be played by Congressional oversight, which particularly calls the regulators to their tasks, so to speak. So this is a matter that we will keep cognizance of.

I want to turn now and ask about the outside auditor in this instance and the accountants and what we might learn from all of that. There was a sharp disagreement, as I understand it, between the outside auditors, the accountants, and the regulators with respect to the valuation of these residual assets. Is that correct?

Mr. GIANNI. Yes, sir.

Chairman SARBANES. What is your recommendation as to what should be done when bank regulators come up against, when you have this clash between the bank regulators' perception of what the appropriate accounting should be and the position taken by the supposedly outside independent auditors?

Mr. GIANNI. At the present time, the statute allows the regulators to impose stricter requirements than the accounting profession. So the statute gives the regulators the opportunity to impose more stringent requirements.

I think that where a disagreement of this magnitude occurs, that it is imperative that the disagreement be raised through an organization. Oftentimes, it is very difficult to get resolution at the staff level, at the examiner level. And I think what needs to happen is that those instances where major disagreements are occurring between the examiner and either the accountants or the board of directors or the management of an institution, it is imperative that the regulator create a culture that makes the examiners comfortable with raising issues, so that they can be decided at the appropriate level within the organization. And in this particular case, the disagreement persisted for a year and in the end, the regulators were proven to be right.

Chairman SARBANES. When Ellen Seidman was before the Committee at the October hearing, then the OTS Director, she recommended, "Congress enact legislation providing that a Federal

bank regulator may issue an accounting dispute letter starting a 60 day clock for resolution of the dispute, if the dispute could result in a lower PCA capital category for the institution. If there is no resolution at the close of this 60 day time period, the regulator's position will be adopted for regulatory accounting purposes." What is your view of that recommendation? Do you have a view on that, Mr. Rush?

Mr. RUSH. I am familiar with her recommendation. My own view is, and it is not one that I have developed, but my view now is that the law already grants sufficient authority to the regulator to make final decisions with respect to accounting rules, and that if you create this new regime, such as a new piece of legislation that creates new rights for institutions, I am not sure you are going to address the issue rather than maybe drag it out a little longer than you want. This is a problem if you cannot force, if the regulator cannot make final decisions as to how you will classify the risk associated to capital and make judgments about the nature of restrictions that then follow at an institution, you have lost the battle. Maybe there ought to be an opportunity for the regulated industry to be heard within a new process, but I am not sure I would be comfortable with new legislation that creates a right under law to hold open a dispute for 30 days, 60 days, or any other period of time.

Chairman SARBANES. So, you think the authority already exists.

Mr. RUSH. I do not think you can fairly read current law——

Chairman SARBANES. Although I think it is clear in the Superior situation that the bank regulators, in effect, were deferring or delaying while they had this hassle——

Mr. RUSH. That is correct.

Chairman SARBANES. ——with the accountant. And it was not until the accountants agreed to reverse themselves—in other words, they got an agreement on the valuation—that the regulators then moved ahead to take regulatory action. Is that not what happened?

Mr. RUSH. That is correct. And that is why PCA will never accomplish what you want if you can tell the regulator you must stand off while we work out this dispute. While you do that, you continue to expose the funds to increased risk.

Chairman SARBANES. Do you have a view on this, Mr. McCool?

Mr. MCCOOL. I am not sure whether this additional authority is really necessary. I am not a lawyer. I cannot speak to that. But I would think that under the current PCA rules, that the regulators can basically take action without waiting for an accounting dispute to be worked out if they think that there is something wrong with the capital calculation, and the capital is not sufficient to support the risks.

Chairman SARBANES. Did any of you in your inquiry determine whether the outside auditors were also doing consulting work for Superior Bank?

Mr. GIANNI. Yes, Mr. Chairman, we did take a look at that. The accountant who was doing the audit opinion, the financial audit opinion, was also providing other services, specifically, valuation services. And the fees for the valuation services were twice as much as the fees, at least twice as much as the fees for the finan-

cial. It sounds like a repeat of history or what is going on in the halls of Congress now.

A couple of things. I think that, from a Federal standpoint, the standards for the Federal auditing community, the General Accounting Office Yellow Book standards, as we love to call them, have recently been changed to prevent this type of activity. And in reading the papers and some of the literature that has been put out by the AICPA, it appears that they are becoming more agreeable to frowning on that type and, in fact, prohibiting that type of activity going on when you are engaged in a financial operation or financial statement.

Chairman SARBANES. Was the consulting work that they were doing, did that have to do with valuing the residuals?

Mr. GIANNI. In my opinion, it was in direct conflict, yes. The examiners——

Chairman SARBANES. So, on the one hand, they valued the residuals and then on the other hand, as the "independent auditor", they, in effect, certified the value of the residuals which they had consulted in determining. Is that the way it worked?

Mr. GIANNI. Well, it would have been nice if they did do the value of the assets. Unfortunately, they did not.

What they did is they attested to the appropriateness of the methodology used in valuing the assets. They did not go behind the process of valuing the assets to verify and attest to the assumptions used to validate those assumptions. They basically said——

Chairman SARBANES. That is pretty clever.

[Laughter.]

They are not actually on the hook on the asset. They just do the methodology. But then they come along and okay what is presented on the basis of having approved this methodology.

Mr. GIANNI. That is the way it worked in Superior.

Chairman SARBANES. Well, no wonder the fund is going to be out this very significant amount of money. I have one final question. This has been a very helpful panel.

I would like each of you, if you could, what do you think we need legislation to do, if anything, in order to address some of the problems which Superior made manifest?

Mr. MCCOOL. I would suggest what you suggested earlier. I think Congressional oversight of the regulators is what is needed from Congress, to look at how the regulators are going about doing their business, to ask questions about whether they are developing expertise and moving along regulations that are necessary to deal with new risks. I do not necessarily see any need for new legislation. I think there would be a lot of use for Congress looking at the implementation of existing legislation and to make sure that it is going in the direction that Congress intended.

Chairman SARBANES. What about legislation that gave power to the FDIC to move in if they wanted to examine?

Mr. MCCOOL. Well, I think there is a lot of——

Chairman SARBANES. There is an agreement now.

Mr. MCCOOL. Yes. I think to give FDIC the back-up authority they need and probably a legislative fix would be useful.

Chairman SARBANES. Mr. Gianni.

Mr. GIANNI. I have, in addition to giving the Chairman the authority for back-up exams, I also think that it has been over 12 years since we passed legislation on Prompt Corrective Action. The environment has changed. It is different.

It is time to relook at Prompt Corrective Action. There may be a need to raise the tripwires. I certainly think, from a resolution standpoint, where an institution fails, that right now, the FDIC—I am talking from the standpoint of the insurer—FDIC does not get involved in the Prompt Corrective Action process until we hit the 2 percent tripwire and go below 2 percent. As we have seen in the number of instances, when we hit 2 percent, institutions close relatively fast and we are left with a lot of loss on our hands.

In order for us to meet the requirements, in order for the FDIC to better meet the requirements of the least-cost test, I think it would be helpful if the legislation would allow FDIC to enter the bank to begin the process at a higher level, rather than just at the critical level as it is right now. So, there is two prongs.

Chairman SARBANES. Yes. Well, I am very interested in this because I think we have to give more attention to preventing these situations from developing. And obviously, that is very cost effective. It seems to me that the industry should have a keen interest in doing this because if you accept these projections of OMB, and I know that there is some argument about them, they are going to get a boost in the assessments. Let me just read this paragraph to you. The projected increase in assessments on BIF-insured banks indicate that OMB analysts expect the funds ratio to fall below 1.25 percent next year. As of September 30, its ratio stood at 1.32 percent. And then you have the problem of the separate SAIF fund as opposed to the BIF fund. These things are going down because they are taking a hit with the various failures of institutions. So, to the extent that we could prevent these failures—Mr. Rush's reference to the arson investigators. We are very good at that in this country. But it does raise the question, why don't we put some of those resources up front into preventing those fires from happening in the first place? Because what is happening now, in addition to the cost to the fund, it is a real blow, I think, to public confidence, and obviously, right now, at an extremely sensitized period. But every time one of these things happens, it raises a further doubt in the public's mind.

Mr. GIANNI. I think you are right, Mr. Chairman. The fund right now, like you said, is at 1.32 percent, if in the BIF, we experience losses in the magnitude of $1.8 billion, the fund hits the 1.25 percent level and we have to begin to consider assessing premiums for deposit insurance.

Chairman SARBANES. Right.

Mr. GIANNI. One of the ways of at least diffusing the risk is merging the funds. I think there are proposals that have been put forward on deposit insurance reform to that end. With the series of losses that we have experienced, if, in the future, a sizable loss were to occur, the fund would be undercapitalized and we would have to, at the least opportune time, put assessments on the banks.

Whereas, the proposal for deposit insurance reform would again give the FDIC a little bit more latitude to decide when to raise or lower the fund level within a range, I think sounds reasonable.

Chairman SARBANES. The problem is that an asymmetrical argument is being made, which is you should not raise it when things are difficult and you are having failings and the fund is diminishing. And that is what the economic circumstance is. On the other hand, when things are going very well and everything seems to be working, then you should not raise it then either because it is argued you do not really need it. So, you are caught out, so to speak. As I listened to the proposals and the arguments being made for them, I have not yet heard anyone resolve that asymmetrical approach to this issue. But they may do so as we work at it. We will see.

Mr. Rush, on legislation, do you have any ideas?

Mr. RUSH. Sure. And before I get to that, let me be sure it is clear. We agree that there are going to be additional failures. This is not merely an OMB projection. Within our community, we are already planning for and anticipating those failures in the current fiscal year for my office, unfortunately.

I agree that we need to rethink PCA both as it relates to the statutory construct and the regulations. It comes too late and relies solely on reports on capital, this lagging indicator, as a basis to deal with problems and really reduces our ability to prevent problems. I hope the regulations and the regulators begin to think with the help of the institutions more about other indicators that need to be taken into account. Certainly the rapid growth indicators, the concentration indicators, have got to be brought into the equation.

We have been talking about something as it relates to Superior or we have been talking in the hundreds of percent of residual assets over tangible capital when the existing handbook for examiners talks about concentrations greater than 25 percent. Yet, throughout this period of time, I am back to your chart. The line on the left continues to go up and nothing happens until we get the accountants to agree with us that there is something terribly wrong with the valuation methods that are being used. But, to be brief, I guess the answer ought to be, yes, let us relook at legislation and particularly as it relates to PCA.

Chairman SARBANES. Okay. I have one final question which is off the topic, but I am just curious. What are your views on how these regulatory agencies are funded in terms of from whence they obtain their budgets? Who wants to take that one on?

Mr. MCCOOL. Well, I guess one of the things that GAO has always suggested is that, in a way similar to OTS and OCC, that FDIC and the Fed might also charge for their examinations, which they currently do not do. And that is one thing that as a position we have taken in the past.

The issue of self-funding again is an interesting one. I know that we also have been mandated by the legislation you referred to earlier to look at the possibility of self-funding for the SEC, which is a project we are about to initiate. So, we are going to be looking at self-funding from a number of perspectives in the near-future.

Chairman SARBANES. Anyone else want to take that on?

Mr. GIANNI. I know what Mr. Hawke's proposal is. It is an interesting proposal. I understand his argument. I think that I personally have concern that the regulators are dependent on the people that they are regulating for their fees. It just intuitively shows a

conflict in my own mind. So that perhaps a better way of funding the OTS and the OCC could be arrived at. I do not have that solution yet, but, obviously, we have the fund, the insurance fund which the FDIC is funded by.

How that process would work, who would make the decisions as to what funds were going to OTS and OCC, right now, the board makes the decisions for FDIC.

Chairman SARBANES. Mr. Rush.

Mr. RUSH. Mr. Orwell would be pleased to know that he was right and that we still do not know what to call a tax.

[Laughter.]

I do not have a recommendation, but user fees or fee structures of any kind to provide for Government services really constitute a tax. I find it remarkable in Treasury—I am in one of those agencies that has to come in and fight for an appropriation each year and make an argument as to why my office provides some public service. I am surrounded by bureaus and offices that rely upon other ways for funding.

I am not sure that is in anyone's interest. When you made your comments about the asymmetrical argument about raising the funding during times when we do not need money, and not having the ability to raise money at a time when we need money, you begin to deal with the real issue of what are we really funding and who are we fooling by calling this tax something other than a tax?

I have bank accounts and the people that I do business with pay fees based upon those accounts, and they fund some very important activities in this country. Whether or not we will ever consider those activities activities that ought to be appropriated by our Federal Government, I do not want to argue. But I think it is clearly inappropriate for us to look at these activities as other than a tax. That is probably what they are.

Chairman SARBANES. Well, if your concern is to make sure that the regulators have adequate resources with which to do their job, and that if they fail to do their job, it has far-reaching consequences for the workings of our economic system, then you have to give a lot of careful thought as to what's the best way to achieve that, particularly over time, so you do not have the fluctuations up and down of the moment. We have a moment now when people are up here running around and it may do lots of things. Who knows? But then when that recedes, the question then becomes—what happens? And that is not what we need. We need to get this thing at a proper level and on a proper course and sustain it and develop the competence that ensures the integrity of these markets and ensures that we do not have these egregious practices that end up—the people who end up taking it in the neck are always, or virtually always, the little people, in a sense. So, I think we need to give careful thought. Well, that is the subject of a different hearing.

We thank you all very much for coming. You have been very helpful and we thank you for these very carefully done and thorough studies and we will stay in close touch on this issue.

Mr. GIANNI. Thank you, Mr. Chairman.

Chairman SARBANES. I would note that next Tuesday, the Committee will begin a series of hearings related to the issues raised not only by Enron, but Enron and other similar situations. And our

first witnesses will be five former chairmen of the Securities and Exchange Commission, who all have agreed to come in and, in effect, launch this set of hearings, which we have now projected for the balance of this month and into March. We hope out of that to gain some perceptions and reach some conclusions about the structure, about systemic changes and alterations that might be made in the structure that would, if not preclude, at least significantly reduce, the likelihood of similar occurrences.

The hearing stands adjourned.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR PAUL S. SARBANES

This morning, the Senate Committee on Banking, Housing, and Urban Affairs holds its second oversight hearing on the failure of an insured depository institution, Superior Bank, FSB. Our witnesses are: The Honorable Jeffrey Rush, Jr., Inspector General of the Department of the Treasury, The Honorable Gaston L. Gianni, Jr., Inspector General of the Federal Deposit Insurance Corporation, and Mr. Thomas McCool, the Managing Director for Financial Markets and Community Investments of the General Accounting Office. Our witnesses will present their respective analyses of the causes of Superior's failure and offer their recommendation for preventing similar losses in the future.

The Committee completed its first hearing on the failure of Superior on October 16. At that time, we received testimony from the regulators—Ellen Seidman, Director of the Office of Thrift Supervision, and John Reich, Board Member of the FDIC—and also from three financial experts, Bert Ely, George Kaufman, and Karen Shaw Petrou.

On July 27, 2001, the OTS closed Superior Bank after finding that the bank was critically undercapitalized. The OTS concluded that Superior's problems arose from a "high-risk business strategy" and that "Superior became critically undercapitalized largely due to incorrect accounting treatment and aggressive assumptions for valuing residual assets."

As of March 1, 2001, Superior reported assets of $1.9 billion. That would make it the largest U.S. insured depository institution by asset size to fail since 1992. The FDIC estimates that Superior's failure win result in a loss to the Savings Association Insurance Fund (SAIF) of approximately $350 million.

Since our last hearing, there have been significant developments.

First, regulatory developments have addressed two issues that were raised in the last hearing. On November 29, 2001, the Federal bank regulators jointly "announced the publication of a final rule that changes their regulatory capital standards to address the treatment of recourse obligations, residual interests, and direct credit substitutes that expose banks, bank holding companies, and thrifts . . . to credit risk." This new rule addresses the question of large holdings of risky residual assets, as happened in Superior's case. On January 29, 2002, the FDIC announced an agreement among the Federal bank regulators that expands the FDIC's examination authority and makes it easier for the FDIC to examine insured banks and thrifts about which it has concerns. This addresses situations in which the FDIC wants to participate in an examination but the primary regulator refuses.

Second, on December 10, the FDIC and OTS reached a $460 million settlement agreement with Superior's holding companies and their owners, the Pritzker and Dworman interests.

Third, with respect to the resolution, the FDIC as conservator has operated the Bank. On November 19, Charter One Bank, FSB, bought Superior's deposit franchise and other assets for a premium of $52.4 million. The FDIC is in the process of selling the Bank's remaining assets.

The focus of today's hearings is the findings and recommendations of the Treasury, the FDIC, and the GAO. In requesting these three agencies in the wake of Superior's failure to assess the reasons why the failure of Superior Bank resulted in such a significant loss to the deposit insurance fund, I specified nine specific areas of analysis, including the timeliness of regulatory response, the role of the outside independent auditor, and coordination among the regulators. I also requested their recommendations for preventing future bank failures, with their attendant losses. Their recommendations take on a new urgency as depository continue to fail, at a cost not only to the insurance fund but also to public confidence in our banking system. Since the failure of Superior just 7 months ago, four other insured banks have failed, with a potential cost to the BIF of some $250–$450 million.

PREPARED STATEMENT OF JEFFREY RUSH, JR.

INSPECTOR GENERAL, U.S. DEPARTMENT OF THE TREASURY

FEBRUARY 7, 2002

Mr. Chairman, Senator Gramm, Members of the Committee, I am delighted to appear before this Committee to discuss our review of the failure of Superior Bank, FSB (Superior), Oakbrook Terrace, Illinois.

As you know, Superior was supervised by the Office of Thrift Supervision (OTS), an agency of the Department of the Treasury. Under the provisions of the Home

Owners Loan Act (HOLA), OTS is responsible for chartering, examining, supervising, and regulating Federal savings associations and Federal savings banks.

HOLA authorizes OTS to examine, supervise, and regulate State-chartered savings associations insured by the Savings Association Insurance Fund. HOLA also authorizes OTS to provide for the registration, examination, and regulation of savings associations, affiliates, and holding companies.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) mandates that the Inspector General of the appropriate Federal banking agency shall make a written report to that agency whenever the deposit insurance fund incurs a material loss. A loss is deemed material if it exceeds the greater of $25 million or 2 percent of the institution's total assets at the time the Federal Deposit Insurance Corporation (FDIC) initiated assistance or was appointed receiver. FDICIA further mandates a 6 month deadline for the report to the appropriate Federal banking agency. On February 6, 2002, as mandated by the FDICIA, my office issued a report on the material loss review (MLR) to the Director OTS, and to the Chairman FDIC and the Comptroller General of the United States.

In my statement today, I first provide an overview of Superior followed by our findings and observations on: (1) the causes of Superior's failure; (2) OTS's supervision of Superior, including the use of Prompt Corrective Action (PCA); and (3) a status report on our on-going audit and investigation of this bank failure.

Overview of Superior

Superior's failure is the largest and most costly thrift failure since 1992. FDIC has estimated that Superior's failure could cost the Savings Association Insurance Fund (SAIF) about $350 million. At the time of its closing in July 2001, Superior had just over $1.9 billion in booked assets, which were largely funded with FDIC insured deposits of about $1.5 billion.

Superior was originally established in 1988. Superior was formerly known as Lyons Savings Bank of Countryside, Illinois, and acquired for about $42.5 million. Beginning in 1993, Superior embarked on a business strategy of significant growth into subprime home mortgages and automobile loans. Superior transferred the loans to a third party, who then sold "asset-backed securities" to investors. The repayment of these securities was supported by the expected proceeds from the underlying subprime loans.

For Superior, the securitization of subprime loans created what is referred to as a residual asset arising from the sold securities and a portion of the loan proceeds that flowed back to Superior. Securitization of subprime loans generated large, noncash earnings and overstated capital levels due to applicable accounting conventions at the time. Superior more than doubled in asset size from about $974 million in 1993 to $2.3 billion in 2001.

Valuing the residual assets was a critical thrift judgment, which depended on the thrift's ability to accurately estimate several factors affecting the underlying cashflows such as default rates and loan prepayments. The large, noncash earnings generated from the subprime loan securitizations masked actual losses from flawed residual asset valuation assumptions and calculations. Superior's true operating results did not become evident to OTS or FDIC until October 2000 when they discovered the inaccurate accounting practices and faulty valuation practices. This led to massive write-downs at the thrift.

Causes of Superior's Failure

Superior's insolvency in July 2001 followed a series of accounting adjustments resulting in losses and capital depletion. When the principal owners failed to implement a capital restoration plan that would have entailed a capital infusion of about $270 million, OTS deemed Superior equity insolvent by $125.6 million.

While the immediate causes of Superior's insolvency in 2001 appear to be incorrect accounting and inflated valuations of residual assets, the root causes of the Superior's failure go back to 1993. Indeed, we believe that Superior exhibited many of the same red flags and indicators reminiscent of problem thrifts of the 1980's and early 1990's. These included (1) rapid growth into a new high-risk activity resulting in an extreme asset concentration; (2) deficient risk management systems relative to validation issues; (3) liberal underwriting of subprime loans; (4) unreliable loan loss provisioning; (5) economic factors affecting asset value; and (6) nonresponsive management to supervisory concerns.

Rapid Growth and Asset Concentration

The impact of the residual assets accounting and valuation adjustments on capital was extensive and occurred in just a year's time. Superior's capital fell three capital categories from "adequately capitalized" in March 2000 to "critically undercapitalized" by March 2001. Such large capital depletion due to a single asset type clearly

reflected an unsafe and unsound practice and condition due to an asset concentration. From the beginning, Superior's concentration in residual assets was apparent. Those assets were valued at $18 million or 33 percent of tangible capital in 1993, and grew to over $996 million or 352 percent of tangible capital by 2000.

Besides the concentration, Superior's risk profile was even greater due to higher than normal credit risk of the underlying subprime loans supporting the residual assets. Despite the heightened risks of Superior's business strategy, it generally maintained capital equivalent to thrifts engaged in traditional lending activities.

Deficient Risk Management Systems

Superior lacked sufficient controls and systems commensurate with Superior's complex and high-risk business activities. For example, Superior lacked established goals for diversification or preset exposure limits established by management and approved by the board. Rather than establish risk limits, management actually appeared to encourage growth. One example was the compensation incentives paid to employees and that was tied to increased loan volume.

Superior also lacked financial information systems that could be reasonably expected to support Superior's complex business strategy. For example, financial systems were not fully integrated, and to some extent relied on manual inputs to generate aggregate balances. Controls and systems over the valuation of residual assets were also weak. Superior relied on an outside third party, Fintek, Inc. of Orangeburg, New York, for the securitizations and residual asset valuation models rather than performing these functions internally. But, Superior paid inadequate attention to Fintek and lacked sufficient controls to ensure that key valuation functions were reliable. For example, fundamental stress testing incorporating varying discount rates, default rates, and prepayments were either lacking or deficient.

Liberal Underwriting

Credit risk was one of the key factors that ultimately affected the residual asset valuations given the dependency on the expected cashflows from the underlying loans. Credit risk also arose from the recourse provisions that Superior provided to investors to enhance the sale of asset-backed securities. Although exposed to credit risk from several fronts, the supervisory records indicate Superior had liberal underwriting practices and inadequate review procedures to detect inflated appraisals. As stated earlier, we found indications that employee bonuses had been tied to increased loan volume. Superior increased the risk by reducing lending quality standards beginning in 1998 and continuing through 2000.

The liberal underwriting was especially evident with Superior's subprime automobile loan business. Automobile loan originations went from $38.7 million in 1995 to nearly $350 million (mostly for used cars) in 1999, a nine-fold increase. The auto loan portfolio had grown to $578.9 million by 2000. Delinquencies and loan losses mounted and the subprime automobile program was discontinued in 2000, but not until Superior had lost an estimated $100 million.

Unreliable Loan Loss Provisioning

OTS's and FDIC examination files characterized Superior's understanding of the Allowance for Loan and Lease Losses (ALLL) provisioning process as seriously deficient. At times examiners would note material excess provisioning, at other times material excess shortfalls.

For example, in 1994 and 1995, OTS advised Superior of the improper inclusion of $1.6 million and $2.6 million, respectively, of residual reserves in the ALLL. The excess provisioning effectively overstated the risk-based capital levels because regulations allow thrifts to include a portion of the ALLL. The overstated risk-based capital levels may have allowed Superior to pay dividends of approxiamtely $11.3 million in excess of Superior's own dividend policy and capital level goals, and may have also allowed Superior to avert PCA brokered deposit restrictions as early as 1995, a time when Superior undertook significant growth.

The OTS also found in 2000 that Superior's ALLL for automobile loans did not cover all the associated risks, lacked specificity, and would not result in adequate allowances. At the time, Superior's available ALLL balance totaled $2.6 million to cover the auto loan portfolio of $578.9 million. Examiners determined that Superior needed at least $14.1 million.

Economic Factors

One reason subprime lending is considered a high-risk activity is that an economic slowdown will tend to adversely affect subprime borrowers earlier and more severely than standard-risk borrowers. Given Superior's focus on subprime lending and concentration in residual assets supported by subprime loans, economic and market factors presented added risks and greater management challenges.

Superior's profitability was dependent on the cashflows of the subprime loans supporting the residual assets. For subprime loans, prepayments occur more frequently than for prime loans both when interest rates decline and borrowers, credit worthiness improves. Increased competition in the subprime markets also increases prepayments as borrowers prepay loans to refinance at more favorable terms. Superior experienced greater than expected prepayments and default rates, which adversely affected residual asset valuations.

Non-responsive Management to Supervisory Concerns

OTS raised supervisory concerns over several areas as early as 1993. However, the supervisory record reflects a pattern, whereby thrift management promises to address those supervisory concerns either were not fulfilled or were not fully responsive. Of note were supervisory concerns regarding the residual assets risks in 1993. At the time, Superior's management provided OTS oral assurances that Superior would reduce risk by upstreaming residual assets to the holding company. However, Superior only upstreamed $31.1 million out of an estimated total of at least $996 million between 1993 and 2000.

OTS warnings also included the need for Superior to establish prescribed exposure limits based on risk considerations such as anticipated loans sales and anticipated capital support. Again, thrift management and the board never established such limits or guiding policies covering the residual asset risks.

OTS's Supervision of Superior

In the early years, OTS's examination and supervision of Superior appeared inconsistent with the institution's increasing risk profile since 1993. It was not until 2000 that OTS expanded examination coverage of residual assets and started meaningful enforcement actions. But by then it was arguably too late given Superior's high level and concentration in residual assets. At times certain aspects of OTS examinations lacked sufficient supervisory skepticism, neglecting the increasing risks posed by the mounting concentration in residual assets. OTS's enforcement response also proved to be too little and too late to curb the increasing risk exposure, and at times exhibited signs of forbearance. We believe that it was basically Superior's massive residual assets concentration and OTS's delayed detection of problem residual asset valuations that effectively negated the early supervisory intervention provisions of Prompt Corrective Action.

We believe OTS's supervisory weaknesses were rooted in a set of tenuous assumptions regarding Superior. Despite OTS's own increasing supervisory concerns, OTS assumed (1) the owners would never allow the bank to fail; (2) Superior management was qualified to safely manage the complexities and high risks of asset securitizations; and (3) external auditors could be relied on to attest to Superior's residual asset valuations. All of these assumptions proved to be false.

Delayed Supervisory Response

Superior's high concentration of residual assets magnified the adverse effects of the accounting and valuation adjustments leading to its insolvency in July 2001. As early as 1993, OTS examiners expressed concerns about Superior's residual assets. However, it was not until December 1999 that Federal banking regulators issued uniform guidance over asset securitizations and related residual assets (referred to as "retained interests" in the guidance). Additionally, the associated accounting standards were not issued until 1996 with Statement of Financial Accounting Standards (SFAS) No. 125, followed by clarifying guidance in 1998, 1999, and the replacement guidance SFAS No. 140 in 2000.

Notwithstanding the absence of regulatory and accounting guidance, we believe OTS neglected to use existing supervisory guidance over concentrations to limit Superior's growth and risk accumulation beginning in 1993. OTS's regulatory handbook alerts examiners to a concentration risk when that concentration exceeds 25 percent of tangible capital. Superior's asset concentration in 1993 was 33 percent. Concentration continued to grow to a high of 352 percent of tangible capital in 2000. Besides the rapid growth, there were other early warning signs of Superior's high risk that OTS appeared to have neglected.

- Superior's residual assets clearly surpassed all other thrifts in the country. At one point in time, the interest strip component of residual assets stood at $643 million—more than the combined total for the next highest 29 thrifts supervised by OTS. In terms of Superior's capital exposure, this residual component amounted to 223 percent of capital compared to 72 percent for the next highest institution.
- OTS headquarters advised field officials in 1997 that subprime loans were considered high risk and warranted additional examiner guidance.

- Superior inaccurately reported residual assets in its Thrift Financial Reports (TFR's) as early as 1993.

We believe that Superior's persistent unfulfilled promises to address the residual asset risks were perhaps the most telling supervisory red flag. OTS originally expressed concern over residual assets in 1992 when Superior acquired its mortgage banking business. At that time, Superior gave oral assurances that either selling or upstreaming the residual assets to the holding company would control the risk. But residual assets only continued to grow in the following years. OTS continually recommended but did not require Superior to reduce its residual asset levels. Instead, OTS accepted Superior's assurances that residual assets would be reduced or that residual assets would be properly managed. Examiners and OTS officials also believed that Superior's principal owners would provide financial assistance should the risks adversely affect Superior.

Ineffective Enforcement Action

OTS did not actively pursue an enforcement action to limit Superior's residual asset growth with a Part 570 Safety and Soundness Compliance Plan (also known as a Part 570 notice) until July 2000. One of the Part 570 provisions required Superior to reduce residual assets to no greater than 100 percent of core capital within a year.

In our MLR, we questioned whether the Part 570 notice was a sufficient sanction given Superior management's prior unfilled commitments to address the residual asset risks. In fact, Superior submitted an amended Part 570 compliance plan in September 2000 and again in November 2000, in effect delaying the Part 570 process by 4 months. Moreover, the action was never effected in terms of OTS officially accepting the plan, and eventually was taken over by subsequent supervisory events. Although grounds existed for a more forceful enforcement action such as a Temporary Cease & Desist order, two OTS senior supervisory officials chose the Part 570 notice because it was not subject to public disclosure, whereas other actions are subject to public disclosure. OTS that public disclosure of an enforcement action might impair Superior's ability to obtain needed financing through loan sales.

Aside from the timing and forcefulness of the enforcement action, we also observed that the Part 570 notice attempted to reduce the concentration risk partly by reducing residual assets to no greater than 100 percent of capital. However, there were no provisions to further mitigate risks by requiring additional capital coverage. This latter enforcement aspect was not addressed until 2001 through other enforcement actions.

Examination Weaknesses Over Valuation and Accounting Problems

Superior's residual asset exposure clearly grew beginning in 1993. Yet, OTS examinations of the residual asset valuations lacked sufficient coverage during the rapid growth years up through 1999. Examiners did not exhibit the supervisory skepticism normally shown over traditional loans. Instead examiners appeared to have unduly relied on others to attest to the carrying value of Superior's residual assets, despite noted TFR reporting errors since 1993.

One specific examination weakness was the lack of sufficient on-site coverage of Fintek at Orangeburg, New York. Fintek provided Superior with consulting services including the basis for the valuation models, underlying assumptions, and calculations. Yet, OTS prior examination coverage of the valuation process was not conducted in Orangeburg but instead at Superior's offices in Oakbrook Terrace, Illinois. It was not until March 2001 that OTS expanded its examination coverage and completed meaningful testing at Fintek, which ultimately led to Superior's residual assets write-down of $150 million in July 2001. We believe the lack of meaningful on-site examination coverage at Fintek could be attributed to several reasons:

- OTS lacked detailed examination procedures covering third party service providers such as Fintek. Although a 1991 OTS examination bulletin describes some of the risk of using a third party service provider such as consultants, it does not outline the supervisory obligations of an examiner in this area.
- Securitized assets were relatively new and complex activities, and examiners may not have had sufficient related expertise to readily recognize the risks and implications of inaccurate valuations, and thus identify when closer scrutiny was warranted. Indeed, OTS's expanded on-site coverage at Fintek in 2001 was seemingly undertaken at FDIC's urging.

A senior OTS official indicated that prior to 2000 there was no compelling reason to be concerned with the residual valuations, and examiners expressed confidence in Superior's management who appeared knowledgeable of the asset securitization business. However, we believe there were indications that closer and earlier on-site examination coverage over the valuation process was warranted. Besides the con-

centration and subprime risks, Superior did not provide sufficient internal audit coverage of the valuation area. In fact, audit committee meetings were infrequent and Fintek operations were "off-limits" despite the many critical services that were provided to Superior.

Undue Reliance Placed on External Auditors

OTS examiners unduly relied on the external auditors to ensure that Superior was following proper accounting rules for residual assets. According to OTS's 1995 Regulatory Handbook on Independent Audits, examiners "may rely" on an external auditor's findings in "low-risk" areas. In high-risk areas, examiners are to conduct a more in-depth review of the auditors work, including a review of the underlying workpapers. Nevertheless, an in-depth examiner review of the auditor's workpapers did not occur until late 2000. The 2000 expanded coverage led to the determination that Superior had incorrectly recorded residual asset by as much as 50 percent, and that the external auditors could not provide sufficient support for Superior's fair value modeling or accounting interpretations.

Another example of undue reliance relates to one of the provisions of the July 2000 Part 570 enforcement action. Superior was required to obtain an independent review of the valuation services produced by Fintek. Superior used the same accounting firm that was auditing its financial statements ending June 30, 2000. Current auditing standards do not preclude using the same firm for valuation services and financial statement audits. But the supervisory record does not show whether examiners even attempted to assess whether the auditor's validations might warrant further examiner review. In addition, OTS records show that the required independent validation had not been completed as specifically required, and there was no indication that OTS ever raised this with Superior in terms of inadequate corrective action.

We believe much of OTS's earlier examinations (1993–1999) that lacked normal supervisory skepticism to test, validate and verify Superior's valuations and procedures can be attributed to a combination of reasons. The supervisory files and interviews with supervisory officials lead us to believe that examiners may not have been fully sensitive to the complexities of a new product for which there was little guidance to assess risk. The apparent supervisory indifference to Superior's mounting risks from 1993 through 1999 was partly sustained by the belief in bank management's expertise, coupled with examiners' undue reliance on the external auditors to attest to Superior's valuations and accounting practices.

Factors Impacting Prompt Corrective Action

Prompt Corrective Action (PCA) provides Federal banking regulators an added enforcement tool to promptly address undercapitalized banks and thrifts. PCA consists of a system of progressively severe regulatory intervention that is triggered as an institution's capital falls below prescribed levels. PCA does not replace or preclude the use of other available enforcement tools (that is, cease and desist order, removal actions) that address unsafe and unsound banking practices before capital becomes impaired.

We believe that some of PCA's early intervention provisions may have been negated by OTS's delayed supervisory response in detecting problems. OTS also appeared to have exercised regulatory forbearance by delaying the recognition of Superior's true capital position in early 2001. OTS also may have failed to enforce one of the PCA restrictions over senior executive officer bonuses. Superior's ability to quickly replace brokered deposits with insured retail deposits possibly raises an aspect of PCA that may warrant further regulatory review.

Delayed Examiner Follow-Up/Delayed Detection

PCA is dependent on a lagging indicator because capital depletion or the need for capital augmentation occurs only as quickly as bank management or regulators recognize problems. Our report notes several instances where supervisory delays likely resulted in not recognizing Superior's true capital position, and as such likely delayed the automatic triggering of certain PCA provisions. These include:

- Delayed examiner follow-up on the 1994 and 1995 reported ALLL deficiencies effectively resulted in overstated capital levels as early as 1996, and again in 1997 and 1999. Had Superior's true capital level been known, perhaps the PCA restriction over the use of brokered deposits could have been invoked earlier to stem the growth and buildup of high-risk, residual assets.
- The delayed detection of the $270 million incorrect accounting practice in 2000 and the inaccurate $150 million residual asset valuations in May 2001 also overstated capital levels. Had these two problems been detected earlier, Superior Bank would likely have been subject to several PCA provisions earlier, such as

submitting a capital restoration plan, PCA's 90 day closure rule, and the severest PCA restrictions such as requiring FDIC prior written approval for certain transactions.

The large number of different problem areas leading to Superior Bank's insolvency does little to evoke the notion that PCA had been a diminished enforcement action. Rather, OTS's delayed detection of so many critical problem areas suggests that the benefits of PCA's early intervention provisions is as much dependent on timely supervisory detection of actual, if not developing, problems, as it is on capital.

Indications of Regulatory Forbearance

We believe that OTS on several occasions extended to Superior regulatory forbearance. These forbearances took the form of either delaying the recognition of known write-downs or providing liberal regulatory interpretations of transactions that effectively allowed Superior to remain above certain PCA capital levels.

Valuations Delayed

After determining Superior had used incorrect accounting practices in January 2001, the resulting $270 million write-down effectively lowered Superior's capital position to the "significantly undercapitalized" level. By May 7, 2001, examiners had clear indications that Superior's overly optimistic valuation assumptions would necessitate additional write-downs of at least $100 million. This additional write-down would have effectively lowered Superior's capital below the 2 percent "critically undercapitalized" level, at which time PCA's severest mandatory restrictions would have been triggered. It appears that the additional write-down had not been immediately made due to OTS's acceptance of Superior's proposed capital restoration plan on May 24, 2001.

Assets Not Recorded

Another example of forbearance relates to Superior applying an accounting rule (for example, "right of setoff") that allowed it to exclude certain assets from being reported in the March 2001 TFR's. The associated assets were loans that Superior had committed to sell, and Superior's accounting treatment effectively served to keep their regulatory capital above the "critically undercapitalized" level. The sales transaction did not meet either regulatory or accounting standards for the right of setoff treatment. Again it appears OTS's approval of the capital restoration plan in May 2001 became the overriding consideration precluding the needed adjustment to the March 2001 TFR.

Noncash Capital Contribution

In another instance, Superior included in the March 2001 TFR a noncash capital contribution consisting of $81 million in residual assets from the holding company. The contribution effectively served to keep Superior's capital above the "critically undercapitalized" level. OTS's Regulatory Handbook does not generally permit the inclusion of noncash assets for determining tangible capital. Although the OTS handbook does provide some flexibility on a case-by-case basis, Superior's tenuous financial condition at the time seemed to have merited closer adherence to the prescribed regulatory policy. OTS requested on May 3, 2001 that Superior provide additional documentation in the form of legal and accounting opinions in support of the transaction. Aside from providing Superior additional time, it seemed incongruous that OTS would accept the residual asset contribution at a time Superior needed to reduce, not increase, its residual asset exposure.

Preferential Application of Risk-Based Capital Requirements

Superior's capital restoration plan approved by OTS on May 24, 2001, included provisions to sell and pledge assets to finance a part of the underlying capitalization arrangement. At issue is OTS's assessment as to how much capital Superior would need to apply against the sold loans and pledged assets. The level of capital that OTS approved under the capital plan was less than normally needed by as much as $148 million according to FDIC calculations. This short fall arises from OTS allowing Superior relief from existing risk based capital standards, which requires subjecting the pledged assets to a single risk weight of 100 percent. Instead, OTS approved a graduated scale extending over 9 years, starting out at 50 percent less than the existing capital requirement, and increasing each subsequent year. The existing capital requirement would not have been reached until June 2005. According to an FDIC memo to OTS, the relief afforded Superior was not consistent with existing capital treatment by the other regulatory agencies on recourse arrangements.

In our report, we also discuss two other observations relative to PCA. We determined that Superior might have violated the PCA mandatory restriction against

paying excessive bonuses to senior officers. Between March and July 2001, a total of $220,000 in bonuses had been paid to 10 senior executives. An OTS official said he had not been aware of the bonuses.

We also reported that the PCA restrictions over the use of brokered deposits might warrant regulatory review. These PCA restrictions serve to curb or reverse growth, and thus risk, by limiting an institution's funding sources. For Superior, these restrictions were automatically triggered in 2000. However, the intended restriction did not appear particularly effective. Int June 2000, brokered deposits totaled $367.2 million, and dropped to $80.9 million by June 2001, a month before it's closing. Insured deposits in June 2000 totaled $1.1 billion and by June 2001 totaled $1.5 billion, effectively replacing the drop in brokered deposits. Although Superior's replacement of brokered deposits with retail insured deposits was within the technical rules of the regulation, we believe the process was not within the intent, particularly with respect to FDIC's potential costs in resolving failures, and curbing growth.

Status of Ongoing Audit and Investigation

We conducted our review of Superior in accordance with generally accepted Government auditing standards. However, we were unable to fully assess certain aspects of OTS's supervision of Superior. This was due to delays in getting access to documents obtained through 24 subpoenas issued by OTS after July 27, 2001. It is our intention to review these documents and to issue a separate report.

We are also currently working with the Office of Inspector General, Federal Deposit Insurance Corporation, and the United States Attorney of the Northern District of Illinois, to determine whether there were any violations of Federal law in connection with the failure of Superior. We will report on the result of that work at an appropriate time.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions you or the other Members of the Committee may have.

PREPARED STATEMENT OF GASTON L. GIANNI, JR.

INSPECTOR GENERAL, FEDERAL DEPOSIT INSURANCE CORPORATION

FEBRUARY 7, 2002

Mr. Chairman, and Members of the Committee, I appreciate the opportunity to appear before this Committee today on the July 2001 failure of Superior Bank, Federal Savings Bank (Superior). My office has prepared a full report providing answers to the nine topics you asked us to address concerning this failure. That report has been provided for the record. In accordance with the Federal Deposit Insurance Act, the Office of Thrift Supervision (OTS) was the Primary Federal Regulator for Superior, responsible for such activities as performing examinations of the safety and soundness of the bank. The Federal Deposit Insurance Corporation's (FDIC) responsibilities included providing deposit insurance and exercising its special examination authority. The scope of our review included an analysis of Superior's operations from 1991 until its failure on July 27, 2001. We also evaluated the regulatory supervision of the institution over the same time period.

For purposes of our testimony, our responses to the nine topics you raised are summarized into four key concerns: Why did this bank fail? What was the role of the principal auditor? What did the regulators do? Why did this failure result in such a large loss to the deposit insurance fund? We will also provide the Committee with the status of the FDIC's resolution of the failed Superior Bank.

Background

By way of background, it is helpful to understand the following information about the nature of Superior's organization, its principal business activity, and the financial outcome of that activity.

Superior was owned by two family interests through a series of holding companies, including Coast-to-Coast Financial Corporation (CCFC). As a Federally chartered thrift, Superior operated across all State lines. In December 1992, CCFC merged a mortgage banking entity, Alliance Funding Company, Inc., with Superior to expand Superior's mortgage lending business. Alliance specialized in "subprime" lending, that is, it originated first and second home mortgage loans to borrowers whose credit was below standard, perhaps because of a history of late payments or filing of personal bankruptcy.

After the merger with Alliance, Superior began generating subprime mortgages for resale, a process commonly referred to as securitization. Through this process,

loans were assembled into pools and eventually sold to investors primarily in the form of highly rated mortgage securities. To attain high ratings, Superior had to offer credit enhancements. To explain, these enhancements protected investors from losses if the cashflows from the underlying mortgage loans were insufficient to pay the principal and interest due on the securities. These credit enhancements shifted the risk from the investors to Superior. If a borrower did not repay a loan, Superior would absorb the loss and still be responsible for making payments to investors.

During 1993, Superior originated and securitized approximately $275 million of subprime mortgage loans. That amount grew significantly each subsequent year and reported net income was similarly increasing during that time. By 1996, Superior's return on assets (ROA) was 7.56 percent, which gave it the distinction of having the highest return on assets of any insured thrift in the Nation—over 12 times more than the average thrift operating in the United States. This ROA would prove to be very misleading, as it was not based on actual cash being received by Superior.

In reality, the actual net income was solely based on gains of security sales—not revenues from ordinary lines of business. As a result, Superior actually operated at a loss every year from 1995 through 1999. By 1999, an operating loss of $26.6 million was overshadowed by almost $186 million in booked gains resulting from the sales. Again these gains were shown for financial reporting purposes but did not exist as cash. Nonetheless, Superior paid substantial dividends on the reported income and other financial benefits to its holding company.

Why Did the Bank Fail?

The failure of Superior Bank was directly attributable to the Bank's Board of Directors and executives ignoring sound risk management principles. They:

- Permitted excessive concentrations in residual assets resulting from subprime lending rather than diversifying risk and did so without adequate financial resources to absorb potential losses;
- Supported flawed valuation and accounting for residual assets that resulted in the recognition of unsubstantiated and unreasonable gains from securitizations;
- Paid dividends and other financial benefits without regard to the deteriorating financial and operating condition of Superior; and
- Overlooked a wide range of accounting and management deficiencies.

These risks went effectively unchallenged by the principal auditor, Ernst and Young (E&Y). The firm issued unqualified audit opinions each year starting in 1990 through June 30, 2000, despite mounting concerns expressed by Federal regulators. As a result, the true financial position and results of operations of Superior were overstated for many years. Superior's reported net income before taxes totaled over $459 million for the 9 year period from 1992 through 2000, derived mainly from unrealized gains from securitization transactions. But these gains were calculated based on overly optimistic and unsubstantiated valuations of residual assets and unreasonable assumptions about the timing of when the cash would be received.

Once the residual assets were appropriately valued and generally accepted accounting principles were correctly applied, Superior was deemed insolvent and OTS appointed the FDIC as receiver on July 27, 2001. At the time, estimated losses to the Savings Association Insurance Fund due to the failure ranged from $426–$526 million.

Excessive Concentrations in Residual Assets

After Superior began securitizing subprime loans, the residual assets grew rapidly in real and comparative terms. From 1995 to 2000 residual assets grew from just over $65 million to a peak of $977 million as of June 30, 2000, when Superior ceased securitization activities. As a percentage of capital, the residual assets grew from just over 100 percent of capital in 1995 to almost 350 percent of capital at June 30, 2000. This increase in concentrations warranted increased supervisory attention.

A tenet of sound banking operations is effective risk management and diversification. However, Superior's Board of Directors resisted regulatory recommendations made as early as 1993 for setting limits on the amount of residual assets held by the institution. This allowed securitization activities to expand beyond the safety net provided by Superior's capital base. Ultimately, during the January 2000 examination, OTS, working with the FDIC, concluded that Superior's actual capital could not support its primary business activities.

The regulators also warned Superior about its high-risk lending activities and liberal and unsupported assumptions used in valuing and accounting for residual assets. The FDIC and OTS recommended that Superior determine the fair market value of the residual assets and make the necessary adjustments. But, Superior's Board and management did not heed the regulators. Superior continued to decline to a point that it was determined to be undercapitalized by the end of 2000 and

write-downs of residual assets totaling $420 million were required to more accurately portray their fair value.

Flawed Valuation and Accounting

Let me explain a bit more about the valuing and accounting for the so-called "gains." The bank and its external auditor used liberal interpretations of generally accepted accounting principles to book gains from securitization transactions. Superior made unrealistic assumptions about the cashflow from pools of loans, and then booked the entire gain on sale, or "profit," upfront. Although booking the gain was generally allowed under generally accepted accounting principles, this represents a major difference from the way most thrifts recognize loan income—accruing income over the life of the loan—and should have received closer scrutiny by the Board of Directors and external auditors. In addition, proper valuation and discounting to present value is required under generally accepted accounting priniciples.

Also, it appears that OTS overly relied on accounting information provided by the bank and validated by E&Y. Not until the January 2000 examination and subsequent October 2000 field visitation, both of which included FDIC involvement, did it become apparent to OTS that this over reliance may have been a mistake. By this time, significant overvaluation of residual assets had occurred and Superior needed recapitalization to remain viable.

When the OTS and FDIC examiners reviewed E&Y work papers in 2000, they discovered that E&Y had made "fundamental errors" in addition to those we discussed previously. E&Y allowed Superior to claim cashflows immediately even though they would not be received until several years later. This along with unrealistic assumptions led OTS and FDIC examiners to determine that Superior's assets were over valued by at least $420 million as of December 31, 2000.

Paying Unearned Dividends and Other Financial Benefits

The higher valuations and resulting inflated net income allowed Superior to pay huge dividends to its holding company. Virtually all of these dividends were paid from so-called gains recognized from securitized transactions. In actuality Superior was experiencing net operating losses from 1995 until it failed. The impact of the reported gains on net income and dividends paid is detailed in our report and shown in the following table.

Calendar Year	Net Income (Includes Imputed Gains) (000's)	Imputed Gains (000's)	Net Income Less Imputed Gains (000's)	Dividends Paid (000's)
1992	$2,795	$1,884	$911	$2,147
1993	20,789	17,920	2,869	19,773
1994	10,915	7,153	3,762	5,793
1995	30,053	31,128	(1,075)	11,655
1996	60,035	63,535	(3,500)	35,291
1997	73,501	91,314	(17,813)	36,556
1998	113,235	137,103	(23,868)	56,022
1999	159,366	185,979	(26,613)	33,556
2000	(11,249)	43,372	(54,621)	0
Total	$459,440	$579,388	$(119,948)	$200,793

Also noteworthy during the year 2000, at a time when Superior was losing money and would have been prohibited from making any dividend payments, it consummated a series of transactions with its holding company that resulted in an additional $36.7 million of financial benefit to the holding company. OTS examiners determined that these transactions were improper because they violated banking laws and regulations pertaining to transactions with affiliates. The most egregious of these transactions occurred when the bank sold loans to its holding company at less than fair market value, and the holding company quickly resold the loans reaping immediate profit of $20.2 million. The holding company never paid for the loans.

Overlooking Accounting and Management Deficiencies

At Superior, the Board of Directors did not adequately monitor on-site management and overall bank operations. Numerous recommendations contained in various OTS examination reports beginning in 1993 were not addressed by the Board of Directors or executive management. These recommendations included:

- Placing limits on residual assets,
- Establishing a dividend policy that reflects the possibility that estimated gains may not materialize,
- Correcting capital calculations,
- writing down the value of various assets, and
- Correcting erroneous data contained in Thrift Financial Reports to the OTS.

What Was the Role of the Principal Auditor?

E&Y, the bank's external auditor from 1990 through 2000, gave Superior unqualified audit opinions every year and did not question the valuations or calculations involving Superior's assets and capital levels. In 1999, E&Y did not question the actions of Superior when it relaxed underwriting standards for making mortgage loans and also used more optimistic assumptions in valuing the residual assets. In 2000, when examiners from the OTS and FDIC started questioning the valuation of the residual assets, E&Y steadfastly maintained that the residual assets were being properly valued by the bank.

During that time, E&Y also was providing nonaudit services to Superior. These services included reviewing the accounting methodology for the residual assets, which the firm concluded was reasonable. Not until January 2001, did E&Y agree with the regulators' position that the value of the residual assets should be reduced by $270 million due to incorrect application of generally accepted accounting principles requiring appropriate discounts and valuation. Our work indicated that E&Y also did not:

- Expand sufficiently its 2000 audit after OTS and FDIC questioned the valuations of Superior's residual assets in the January 2000 examination;
- Ensure that Superior made adjustments to capital required by OTS as part of the 2000 audit;
- Disclose as a qualification to its 2000 unqualified audit opinion that Superior may not have been able to continue as a "going concern" because of its weak capital position as reflected in poor composite ratings by Federal regulators; and
- Perform a documented, independent valuation of Superior's residual assets as part of the annual audits, but instead only reviewed Superior's valuation methodology and did not perform sufficient testing on securitization transactions.

OTS concluded that Superior's June 30, 2000 financial statements were not fairly stated, contrary to the E&Y opinion. OTS recommended to the Board of Directors that the opinion of E&Y should be rejected and the financial statements restated.

What Did the Regulators Do?

Banking and thrift regulators must also ensure that the accounting principles used by financial institutions adequately reflect prudent and realistic measurements of assets. The FDIC as insurer must coordinate with the primary Federal regulators who conduct examinations of the institutions. In addition, the Congress has enacted legislation addressing Prompt Corrective Action standards when a financial institution fails to maintain adequate capital. These processes were not fully effective with respect to Superior.

OTS Did Not Appropriately Limit the Risk Assumed by the Bank

While OTS examination reports identified many of the bank's problems early on, OTS did not adequately follow-up and investigate the problems—particularly the residual assets carried by the bank. Also, the numerous recommendations contained in various OTS examination reports beginning in 1993 were not addressed by Superior's management and did not receive further attention from the OTS. These issues included placing limits on residual assets, establishing a dividend policy with consideration given to the imputed but unrealized gains from the residual assets, errors in the calculation of the Allowance for Loan and Lease Losses, and Thrift Financial Report errors.

OTS appeared to rely mostly on representations made by the bank and validated by its outside auditors. Also, OTS placed undue reliance on the ability of the owners of the bank's holding company to inject capital if it was ever needed. However, when an injection of capital was needed in 2001, the owners did not provide the necessary capital as they agreed to do in the OTS-approved recapitalization plan. Warning signs were evident for many years, yet no formal supervisory action was taken until July 2000, which ultimately proved too late. More timely action could potentially have avoided at least some of the ultimate loss.

Our review of examination reports dating back to 1993 indicated that OTS did not fully analyze and assess the potential risk that gains on securitization transactions presented to earnings and to assets of the institution. While OTS identified the volume of gains recorded and noted that the gains were unrealized and subject

to change, they did not analyze and assess the bank's performance without those gains or on a realized cashflow basis.

Coordination Between Regulators Was Less than Effective

Coordination between regulators could have been better. OTS denied the FDIC's request to participate in the regularly scheduled January 1999 safety and soundness examination, delaying any FDIC examiner on-site presence for approximately one year. The FDIC has special examination authority under section 10(b) of the Federal Deposit Insurance Act to make special examination of any insured depository institution. An earlier FDIC presence on-site at the bank may have helped to reduce losses that will ultimately be incurred by the Savings Association Insurance Fund. FDIC examiners were concerned over the residual interest valuations in December 1998. However, when OTS refused an FDIC request for a special examination, FDIC did not pursue the matter with its Board. Working hand-in-hand in the 2000 examination, regulators were able to uncover numerous problems, including residual interest valuations.

Prompt Corrective Action Was Ineffective

In 1991, the Congress enacted Section 38 of the Federal Deposit Insurance Act entitled Prompt Corrective Action, or PCA. Under PCA, regulators may take increasingly severe supervisory actions when an institution's financial condition deteriorates. The overall purpose of PCA is to resolve the problems of insured depository institutions before their capital is fully depleted and thus limit losses to the deposit insurance funds. For those institutions that do not meet minimal capital standards, regulators may impose restrictions on dividend payments, limit management fees, curb asset growth, and restrict activities that pose excessive risk to the institution. Unfortunately, none of this occurred at Superior until it was too late to be effective. A PCA notice was issued to Superior on February 12, 2001, less than 6 months before it failed.

The failure of Superior Bank underscores one of the most difficult challenges facing bank regulators today—how to limit risk assumed by banks when their profits and capital ratios make them appear financially strong. Risk-focused examinations adopted by all the agencies have attempted to solve this challenge; however, the recent failures of Superior Bank, First National Bank of Keystone, and BestBank demonstrated the need for further improvement.

In addition, beginning with the January 2000 examination, we believe that the OTS used a methodology to compute Superior's capital that artificially increased the capital ratios, thus avoiding provisions of PCA. OTS used a post-tax capital ratio to classify Superior as "adequately capitalized." If a pre-tax calculation had been used, Superior would have been "undercapitalized," and more immediately subjected to various operating constraints under PCA. These constraints may have precluded Superior management from taking actions late in 2000 that were detrimental to the financial condition of the institution.

Loss to the Savings Association Insurance Fund

As of December 31, 2001 the FDIC estimated that Superior's failure will result in a range of loss to the Savings Association Insurance Fund of approximately $300 to $350 million. This loss estimate includes the benefit of a settlement agreement in the amount of $460 million entered into between the FDIC and owners of the bank's holding companies. Under the agreement, an affiliate of the bank's former holding company paid $100 million to the Government in December 2001 and agreed to pay an additional $360 million in equal annual installments without interest over 15 years, starting in December 2002. If these payments are not made, the losses will substantially increase.

Resolution of Superior

The FDIC Board of Directors determined that a conservatorship would be the least cost alternative for the Savings Association Insurance Fund. This decision was made, in part, because the FDIC did not have sufficient information to develop other possible resolution alternatives. The FDIC's access to Superior was limited partly based on the fact that Superior's owners were in the process of implementing an OTS-approved capital restoration plan purported to address Superior's capital problems. Superior's owners did not implement the approved plan, and OTS notified Superior of its critically undercapitalized condition 1 day prior to consideration of the Failing Bank Case for Superior by the FDIC Board of Directors. Consequently, complete information on a range of resolution alternatives was not available to the FDIC to make the least cost decision for Superior's resolution.

The FDIC has made progress in preparing remaining assets in the receivership for sale and most sales efforts should be completed in the second quarter of 2002. We are continuing to track the FDIC's progress.

New Rule To Amend the Regulatory Capital Treatment of Residual Assets

On November 29, 2001 the Federal bank and thrift regulatory agencies issued a new rule that changes, among other things, the regulatory capital treatment of residual assets in asset securitizations. The rule, which became effective on January 1, 2002, addresses the concerns associated with residuals that exposed financial institutions like Superior Bank to high levels of credit and liquidity risk interests. Essentially the new rule limits residual assets to 25 percent of capital. In our opinion, had Superior Bank operated in accordance with this new rule, it would not have incurred the losses it did and may have avoided failure.

Recommendations

Our review identified areas in which we believe regulatory oversight could be strengthened. These include:

- Reviewing the external auditor's working papers for institutions that operate high-risk programs, such as subprime lending and securitizations;
- Following up on "red flags" that indicate possible errors or irregularities;
- Consulting with other regulators when they encounter complex assets such as those at Superior Bank; and
- Following up on previous examination findings and recommendations to ensure bank management has addressed examiner concerns.

In a related audit report that we will be releasing in the near future, we are recommending that the FDIC take actions to strengthen its special examination authority. Last week, the FDIC Board of Directors authorized an expanded delegation of authority for its examiners to conduct examinations, visitations, or other similar activities of insured depository institutions. This expanded delegation implements an interagency agreement outlining the circumstances under which the FDIC will conduct examinations of institutions not directly supervised by the FDIC.

While this agreement represents progress for interagency examination coordination, it still places limits on the FDIC's access as insurer. Had the provisions of this agreement been in effect in the 1990's, it would not have ensured that the FDIC could have gained access to Superior Bank without going to its Board when it requested so in December 1998. At that time, the bank was 1-rated from the previous OTS examination and there was disagreement as to whether there was sufficient evidence of material deteriorating conditions. To guarantee the FDIC's independence as the insurer, we believe that the statutory authority for the FDIC's special examination authority should be vested with the FDIC Chairman.

Last, we will be recommending that FDIC take the initiative in working with other regulators to develop a uniform method of calculating the relevant capital ratios used to determine an insured depository institution's Prompt Corrective Action category.

Conclusion

In summary, the ability of any bank to operate in the United States is a privilege. This privilege carries with it certain fundamental requirements: accurate records and financial reporting on an institution's operations, activities, and transactions; adequate internal controls for assessing risks and compliance with laws and regulations; as well as the utmost credibility of the institution's management and its external auditors. Most of these requirements were missing in the case of Superior Bank. A failure to comply with reporting requirements, inadequate internal controls, a continuing pattern of disregard of regulatory authorities, flawed and nonconforming accounting methodology, and the potential for the continuation of unsafe and unsound practices left regulators with little choice but to close Superior Bank on July 27, 2001.

Superior Bank and the resulting scrutiny it has received will hopefully provide lessons learned on the roles played by bank management, external auditors, and the regulators so that we may better avoid through improved communication, methodologies, and policies, the events that led to the institution's failure.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other Members of the Committee may have.

PREPARED STATEMENT OF THOMAS J. McCOOL

MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT
U.S. GENERAL ACCOUNTING OFFICE

FEBRUARY 7, 2002

Mr. Chairman and Members of the Committee, we are pleased to be here to discuss our analysis of the failure of Superior Bank, FSB, a Federally chartered savings bank located outside Chicago, IL. Shortly after Superior Bank's closure on July 27, 2001, the Federal Deposit Insurance Corporation (FDIC) projected that the failure of Superior Bank would result in a $426–$526 million loss to the deposit insurance fund.[1] The magnitude of the projected loss to the deposit insurance fund resulted in questions being raised by Congress and industry observers about what went wrong at Superior, how it happened, and what steps can be taken to reduce the likelihood of a similar failure.

Our testimony today (1) describes the causes of the failure of Superior Bank; (2) discusses whether external audits identified problems with Superior Bank, and; (3) evaluates the effectiveness of Federal supervision of Superior, including the coordination between the primary regulator—the Office of Thrift Supervision (OTS)—and the FDIC. Finally, we discuss the extent that issues similar to those associated with Superior's failure were noted in Material Loss Reviews conducted by inspectors general on previous bank failures.

Our testimony is based on our review of OTS and FDIC files for Superior Bank, including reports of on-site examinations of the bank and off-site monitoring and analysis, and interviews with OTS and FDIC officials, including officials in the Chicago offices who had primary responsibility for Superior Bank. The scope of our work on the conduct of Superior's external auditors was limited due to the ongoing investigation and potential litigation by FDIC and OTS on issues surrounding the failure of Superior Bank.

Summary

The key events leading to the failure of Superior Bank were largely associated with the business strategy adopted by Superior Bank's management of originating and securitizing subprime loans on a large scale. This strategy resulted in rapid growth and a high concentration of extremely risky assets. Compounding this concentration in risky assets was the failure of Superior Bank's management to properly value and account for the interests it had retained in pooled home mortgages.

Superior Bank generated high levels of "paper profits" that overstated its capital levels. When Federal regulators were finally able to get Superior Bank to apply proper valuation and reporting practices, Superior Bank became significantly undercapitalized. When the owners of Superior Bank failed to contribute additional capital, the regulators were forced to place Superior into receivership.

Superior's external auditor, Ernst & Young, also failed to detect the improper valuation of Superior's retained interests until OTS and FDIC insisted that the issue be reviewed by Ernst & Young's national office. As noted earlier, FDIC and OTS are investigating the role of the external auditor in Superior's failure, with an eye to potential litigation.

Federal regulators were clearly not effective in identifying and acting on the problems at Superior Bank early enough to prevent a material loss to the deposit insurance fund. OTS, Superior's primary supervisor, bears the main responsibility for not acting earlier. Superior may not have been a problem bank back in the mid-1990's, but the risks of its strategy and its exposure to revaluation of the retained interests merited more careful and earlier attention. FDIC was the first to recognize the problems in Superior's financial situation, although the problems had grown by the time that FDIC recognized them in late 1998.

Both agencies were aware of the substantial concentration of retained interests that Superior held, but the apparently high level of earnings, the apparently adequate capital, and the belief that the management was conservatively managing the institution limited their actions. Earlier response to the "concerns" expressed in examination reports dating to the mid-1990's may not have been sufficient to avoid the failure of the bank, but it likely would have prevented subsequent growth and thus limited the potential loss to the insurance fund.

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[1] The amount of the expected loss to the insurance fund is still in question. To settle potential claims, former coowners of Superior entered into a settlement with FDIC and OTS in December 2001. The settlement calls for a payment to FDIC of $460 million, of which $100 million already has been paid. The remaining $360 million is to be paid over the next 15 years. The ultimate cost to the insurance fund will be determined by the proceeds that FDIC obtains from the sale of the failed institution's assets and other factors.

Problems in communication between OTS and FDIC appear to have hindered a coordinated supervisory approach. FDIC has recently announced that it has reached agreement with the other banking regulators to establish a better process for determining when FDIC will use its authority to examine an insured institution. While GAO welcomes improvements in this area, neither OTS nor FDIC completely followed the policy in force during 1998 and 1999, when OTS denied FDIC's request to participate in the 1999 examination. Thus, following through on policy implementation will be as important as the design of improved policies for involving FDIC in future bank examinations.

Background

Superior Bank was formed in 1988 when the Coast-to-Coast Financial Corporation, a holding company owned equally by the Pritzker and Dworman families,[2] acquired Lyons Savings, a troubled Federal savings and loan association. From 1988 to 1992, Superior Bank struggled financially and relied heavily on an assistance agreement from the Federal Savings and Loan Insurance Corporation (FSLIC).[3] Superior's activities were limited during the first few years of its operation, but by 1992, most of the bank's problems were resolved and the effects of the FSLIC agreement had diminished. OTS, the primary regulator of Federally chartered savings institutions, had the lead responsibility for supervising Superior Bank while FDIC, with responsibility to protect the deposit insurance fund, acted as Superior's backup regulator. By 1993, OTS and FDIC had given Superior a composite CAMEL "2" rating[4] and, at this time, FDIC began to rely only on off-site monitoring of Superior.

In 1993, Superior's management began to focus on expanding the bank's mortgage lending business by acquiring Alliance Funding Company. Superior adopted Alliance's business strategy of targeting borrowers nationwide with risky credit profiles, such as high debt ratios and credit histories that included past delinquencies—a practice known as subprime lending. In a process known as securitization, Superior then assembled the loans into pools and sold interest in these pools—such as rights to principal and/or interest payments—through a trust to investors, primarily in the form of AAA-rated mortgage securities. To enhance the value of these offerings, Superior retained the securities with the greatest amount of risk and provided other significant credit enhancements for the less risky securities. In 1995, Superior expanded its activities to include the origination and securitization of subprime automobile loans.

In December 1998, FDIC first raised concerns about Superior's increasing levels of high-risk, subprime assets and growth in retained or residual interests. However, it was not until January 2000 that OTS and FDIC conducted a joint exam and downgraded Superior's CAMELS rating to a "4," primarily attributed to the concentration of residual interest holdings. At the end of 2000, FDIC and OTS noted that the reported values of Superior's residual interest assets were overstated and that the bank's reporting of its residual interest assets was not in compliance with the Statement of Financial Accounting Standards (SFAS) No. 125. Prompted by concerns from OTS and FDIC, Superior eventually made a number of adjustments to its financial statements. In mid-February 2001, OTS issued a Prompt Corrective Action (PCA) notice to Superior because the bank was significantly undercapitalized. On May 24, OTS approved Superior's PCA capital plan. Ultimately, the plan was never implemented, and OTS closed the bank and appointed FDIC as Superior's receiver on July 27, 2001. (A detailed chronology of the events leading up to Superior's failure is provided in Appendix I.)

Causes of Superior Bank's Failure

Primary responsibility for the failure of Superior Bank resides with its owners and managers. Superior's business strategy of originating and securitizing subprime loans appeared to have led to high earnings, but more importantly its strategy resulted in a high concentration of extremely risky assets. This high concentration of

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[2] The Pritzkers are the owners of the Hyatt Hotels, and the Dwormans are prominent New York real estate developers.

[3] This assistance agreement included capital protection provisions and called for reimbursement of expenses for collecting certain problem assets, payment of 22.5 percent of pre-tax net income to FSLIC, and payment of a portion of certain recoveries to the FSLIC. (In later years, there was a disagreement over certain provisions to the assistance agreement and lawsuits were filed.)

[4] OTS and the other regulators use the Uniform Financial Institution Rating System to evaluate a bank's performance. CAMEL is an acronym for the performance rating components: capital adequacy, asset quality, management administration, earnings, and liquidity. An additional component, sensitivity to market risk, was added effective January 1, 1997, resulting in the acronym CAMELS. Ratings are on a 1 to 5 scale with 1 being the highest, or best, score and 5 being the lowest, or worst, score.

risky assets and the improper valuation of these assets ultimately led to Superior's failure.

Concentration of Risky Assets

In 1993, Superior Bank began to originate and securitize subprime home mortgages in large volumes. Later, Superior expanded its securitization activities to include subprime automobile loans. Although the securitization process moved the subprime loans off its balance sheet, Superior retained the riskier interests in the proceeds from the pools of securities it established. Superior's holdings of this retained interest exceeded its capital levels going as far back as 1995.

Retained or residual interests[5] are common in asset securitizations and often represent steps that the loan originator takes to enhance the quality of the interests in the pools that are offered for sale. Such enhancements can be critical to obtaining high credit ratings for the pool's securities. Often, the originator will retain the riskiest components of the pool, doing so to make the other components easier to sell. The originator's residual interests, in general, will represent the rights to cashflows or other assets after the pool's obligations to other investors have been satisfied.

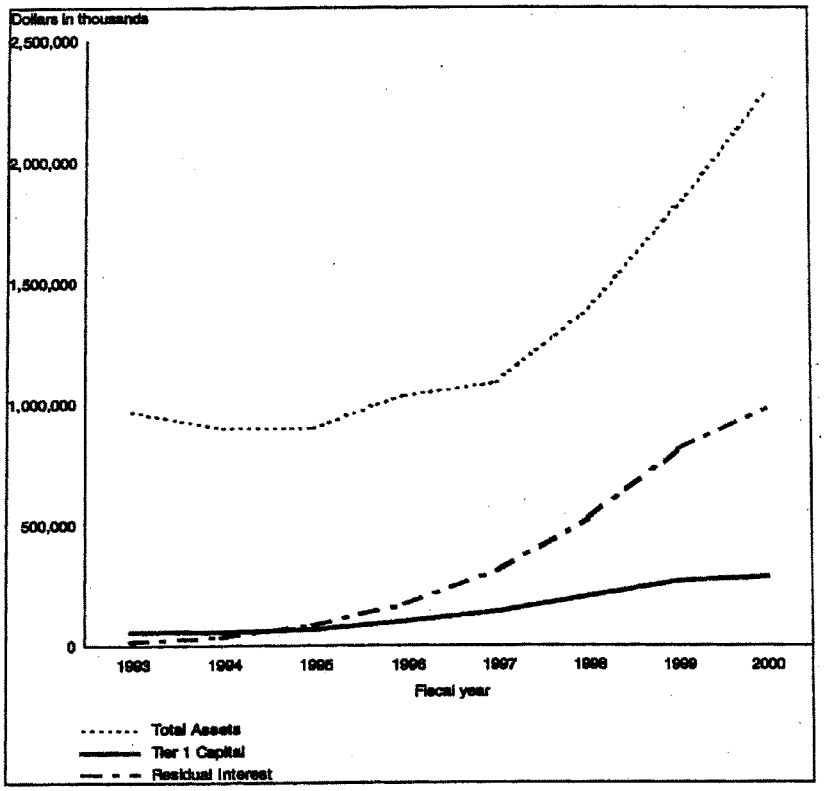
Overcollateralization assets are another type of residual interest that Superior held. To decrease risk to investors, the originator may overcollateralize the securitization trust that holds the assets and is responsible for paying the investors. An originator can overcollateralize by selling the rights to $100 in principal payments, for instance, while putting assets worth $105 into the trust, essentially providing a cushion, or credit enhancement, to help ensure that the $100 due investors is paid in event of defaults in the underlying pool of loans (credit losses). The originator would receive any payments in excess of the $100 interest that was sold to investors after credit losses are paid from the overcollateralized portion.

As shown in Figure 1, Superior's residual interests represented approximately 100 percent of Tier 1 capital on June 30, 1995.[6] By June 30, 2000, residual interest represented 348 percent of Tier 1 capital. This level of concentration was particularly risky given the complexities associated with achieving a reasonable valuation of residual interests.

[5] These interests are known as residuals because they receive the last cashflows from the loans.

[6] Tier 1 capital consists primarily of tangible equity capital—equity capital plus cumulative preferred stock (including related surplus)—minus all intangible assets, except for some amount of purchased mortgage servicing rights.

Figure 1: Superior's Total Assets, Residuals, and Tier 1 Capital from 1993 to 2000



Note: Data are as of June 30 for each fiscal year shown.

Source: Superior Bank's financial statements and OTS.

Superior's practice of targeting subprime borrowers increased its risk. By targeting borrowers with low credit quality, Superior was able to originate loans with interest rates that were higher than market averages. The high interest rates reflected, at least in part, the relatively high credit risk associated with these loans. When these loans were then pooled and securitized, their high interest rates relative to the interest rates paid on the resulting securities, together with the high valuation of the retained interest, enabled Superior to record gains on securitization transactions that drove its apparently high earnings and high capital. A significant amount of Superior's revenue was from the sale of loans in these transactions, yet more cash was going out rather than coming in from these activities.

In addition to the higher risk of default related to subprime lending, there was also prepayment risk. Generally, if interest rates decline, a loan charging an interest rate that is higher than market averages becomes more valuable to the lender. However, lower interest rates could also trigger higher than predicted levels of loan prepayment—particularly if the new lower interest rates enable subprime borrowers to qualify for refinancing at lower rates. Higher-than-projected prepayments negatively impact the future flows of interest payments from the underlying loans in a securitized portfolio.

Additionally, Superior expanded its loan origination and securitization activities to include automobile loans. The credit risk of automobile loans is inherently higher than that associated with home mortgages, because these loans are associated with even higher default and loss rates. Auto loan underwriting is divided into classes of credit quality (most commonly A, B, and C). Some 85 percent of Superior Banks auto loans went to people with B and C ratings. In Superior's classification system,

these borrowers had experienced credit problems in the past because of unusual circumstances beyond their control (such as a major illness, job loss, or death in the family) but had since resolved their credit problems and rebuilt their credit ratings to a certain extent. As with its mortgage securitizations, Superior Bank was able to maintain a high spread between the interest rate of the auto loans and the yield that investors paid for the securities based on the pooled loans. However, Superior's loss rates on its automobile loans as of December 31, 1999 were twice as high as Superior's management had anticipated.

Valuation of Residual Interests

Superior Bank's business strategy rested heavily on the value assigned to the residual interests that resulted from its securitization activities. However, the valuation of residual interests is extremely complex and highly dependent on making accurate assumptions regarding a number of factors. Superior overvalued its residual interests because it did not discount to present value the future cashflows that were subject to credit losses. When these valuations were ultimately adjusted, at the behest of the regulators, the bank became significantly undercapitalized and eventually failed.

There are significant valuation issues and risks associated with residual interests. Generally, the residual interest represents the cashflows from the underlying mortgages that remain after all payments have been made to the other classes of securities issued by the trust for the pool, and after the fees and expenses have been paid. As the loan originator, Superior Bank was considered to be in the "first-loss" position (that is, Superior would suffer any credit losses suffered by the pool, before any other investor.) Credit losses are not the only risks held by the residual interest holder. The valuation of the residual interest depends critically on how accurately future interest rates and loan prepayments are forecasted. Market events can affect the discount rate, prepayment speed, or performance of the underlying assets in a securitization transaction and can swiftly and dramatically alter their value.

The Financial Accounting Standards Board (FASB) recognized the need for a new accounting approach to address innovations and complex developments in the financial markets, such as securitization of loans. Under SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,"[7] which became effective after December 31, 1996, when a transferor surrenders control over transferred assets, it should be accounted for as a sale. The transferor should recognize that any retained interest in the transferred assets should be reported in its statement of financial position based on the fair value. The best evidence of fair value is a quoted market price in an active market, but if there is no market price, the value must be estimated. In estimating the fair value of retained interests, valuation techniques include estimating the present value of expected future cashflows using a discount rate commensurate with the risks involved. The standard states that those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In 1999, FASB explained that when estimating the fair value for retained interests used as a credit enhancement, it should be discounted from the date when it is estimated to become available to the transferor.[8]

Superior Bank did not properly value the residual interest assets it reported on its financial statements. Since those assets represented payments that were to be received in the future only after credit losses were reimbursed, they needed to be discounted at an appropriate risk-adjusted rate, in order to recognize that a promise to pay in the future is worth less than a current payment. Superior did not use discounting when valuing its residual interest related to overcollateralization. However, as a credit enhancement, the overcollateralized asset is restricted in use under the trust and not available to Superior until losses have been paid under the terms of the credit enhancement. The result was that Superior Bank reported assets, earnings, and capital that were far in excess of their true values. In addition, there were other issues with respect to Superior's compliance with SFAS No. 125. When Superior finally applied the appropriate valuation techniques and related accounting to

[7] SFAS No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, issued September 2000, replaced SFAS No. 125.

[8] This concept is reiterated in FASB's *A Guide to Implemention of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers,* Issued July 1999 and revised September 1999. When estimating the fair value of credit enhancements (retained interest), the transferor's assumptions should include the period of time that its use of the asset is restricted, reinvestment income, and potential losses due to uncertainties. One acceptable valuation technique is the "cash out" method, in which cashflows are discounted from the date that the credit enhancement becomes available.

the residual interests in early 2001, at the urging of OTS, Superior was forced to take a write-off against its capital and became "significantly undercapitalized."

Regulators' Concerns About the Quality of the External Audit

Federal regulators now have serious concerns about the quality of Ernst & Young's audit of Superior Banks financial statements for the fiscal year ending June 30, 2000. This audit could have highlighted the problems that led to Superior Bank's failure but did not. Regulators' major concerns related to the audit include: (1) the inflated valuation of residual interest in the financial statements and (2) the absence of discussion on Superior's ability to continue in business in the auditor's report.

The accounting profession plays a vital role in the governance structure for the banking industry. In addition to bank examinations, independent certified public accountant audits are performed to express an opinion on the fairness of bank's financial statements and to report any material weaknesses in internal controls. Auditing standards require public accountants rendering an opinion on financial statements to consider the need to disclose conditions that raise a question about an entity's ability to continue in business. Audits should provide useful information to Federal regulators who oversee the banks, depositors, owners, and the public. When financial audits are not of the quality that meets auditing standards, this undermines the governance structure of the banking industry.

Federal regulators believed that Ernst & Young auditors' review of Superior's valuation of residuals failed to identify the overvaluation of Superior's residual interests in its fiscal year 2000 financial statements. Recognizing a significant growth in residual assets, Federal regulators performed a review of Superior's valuation of its residuals for that same year and found that it was not being properly reported in accordance with Generally Accepted Accounting Principles (GAAP). The regulators believed the incorrect valuation of the residuals had resulted in a significant overstatement of Superior's assets and capital. Although Ernst & Young's local office disagreed with the regulators findings, Ernst & Young's national office concurred with the regulators. Subsequently, Superior revalued these assets resulting in a $270 million write-down of the residual interest value. As a result, Superior's capital was reduced and Superior became significantly undercapitalized. OTS took a number of actions, but ultimately had to close Superior and appoint FDIC as receiver.

An FDIC official stated that Superior had used this improper valuation technique not only for its June 30, 2000, financial statements, but also for the years 1995 through 1999. To the extent that was true, Superior's earnings and capital were likely overstated during those years, as well. However, in each of those fiscal years, from 1995 through 2000, Superior received an unqualified, or "clean," opinion from the Ernst & Young auditors.

In Ernst & Young's audit opinion, there was no disclosure of Superior's questionable ability to continue as a going concern. Yet, 10 months after the date of Ernst & Young's audit opinion on September 22, 2000, Superior Bank was closed and placed into receivership. Auditing standards provide that the auditor is responsible for evaluating "whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time." This evaluation should be based on the auditor's "knowledge of relevant conditions and events that exist at or have occurred prior to the completion of fieldwork." FDIC officials believe that the auditors should have known about the potential valuation issues and should have evaluated the "conditions and events" relating to Superior's retained interests in securitizations and the subsequent impact on capital requirements. FDIC officials also believe that the auditors should have known about the issues at the date of the last audit report, and there was a sufficient basis for the auditor to determine that there was "substantial doubt" about Superior's "ability to continue as a going concern for a reasonable period of time." Because Ernst & Young auditors did not reach this conclusion in their opinion, FDIC has expressed concerns about the quality of the audit of Superior's fiscal year 2000 financial statements.

FDIC has retained legal and forensic accounting assistance to conduct an investigation into the failure of Superior Bank. This investigation includes not only an examination of Superior's lending and investment practices but also a review of the bank's independent auditors, Ernst & Young. It involves a thorough review of the accounting firm's audit of the bank's financial statements and role as a consultant and advisor to Superior on valuation issues. The major accounting and auditing issues in this review will include: (1) an evaluation of the overcollateralized assets valuation as well as other residual assets; (2) whether "going concern" issues should have been raised had Superior Bank's financials been correctly stated and; (3) an evaluation of both the qualifications and independence of the accounting firm. The target date for the final report from the forensic auditor is May 1, 2002. OTS offi-

cials told us that they have opened a formal investigation regarding Superior's failure and have issued subpoenas to Ernst & Young, among others.

Effectiveness of OTS and FDIC Supervision of Superior Bank

Our review of OTS's supervision of Superior Bank found that the regulator had information, going back to the mid-1990's, that indicated supervisory concerns with Superior's substantial retained interests in securitized, subprime home mortgages and recognition that the bank's soundness depended critically on the valuation of these interests. However, the high apparent earnings of the bank, its apparently adequate capital levels, and supervisory expectations that the ownership of the bank would provide adequate support in the event of problems appear to have combined to delay effective enforcement actions. Problems with communication and coordination between OTS and FDIC also created a delay in supervisory response after FDIC raised serious questions about the operations of Superior. By the time that the PCA directive was issued in February 2001, Superior's failure was probably inevitable.

Weaknesses in OTS's Oversight of Superior

As Superior's primary regulator, OTS had the lead responsibility for monitoring the bank's safety and soundness. Although OTS identified many of the risks associated with Superior's business strategy as early as 1993, it did not exercise sufficient professional skepticism with respect to the "red flags" it identified with regards to Superior's securitization activities. Consequently, OTS did not fully recognize the risk profile of the bank and thus did not address the magnitude of the bank's problems in a timely manner. Specifically:

- OTS's assessment of Superior's risk profile was clouded by the banks apparent strong operating performance and higher-than-peer leverage capital;
- OTS relied heavily on management's expertise and assurances; and
- OTS relied on the extemal audit reports without evaluating the quality of the external auditors' review of Superior's securitization activities.

OTS's Supervision of Superior was Influenced by its Apparent High Earnings and Capital Levels

OTS's ratings of Superior from 1993 through 1999 appeared to have been heavily influenced by Superior's apparent high earnings and capital levels. Beginning in 1993, OTS had information showing that Superior was engaging in activities that were riskier than those of most other thrifts and merited close monitoring. Although neither subprime lending nor securitization is an inherently unsafe or unsound activity, both entail risks that bank management must manage and its regulator must consider in its examination and supervisory activities. While OTS examiners viewed Superior Bank's high earnings as a source of strength, a large portion of these earnings represented estimated payments due sometime in the future and thus were not realized. These high earnings were also indicators of the riskiness of the underlying assets and business strategy. Moreover, Superior had a higher concentration of residual interest assets than any other thrift under OTS's supervision. However, OTS did not take supervisory action to limit Superior's securitization activities until after the 2000 examination.

According to OTS's Regulatory Handbook, greater regulatory attention is required when asset concentrations exceed 25 percent of a thrift's core capital.[9] As previously discussed, Superior's concentration in residual interest securities equaled 100 percent of Tier 1 capital in June 30, 1995 and grew to 348 percent of Tier 1 capital in June 30, 2000. However, OTS's examination reports during this period reflected an optimistic understanding of the implications for Superior Bank. The examination reports consistently noted the risks associated with such lending and related residual interest securities were balanced by Superior's strong earnings, higher-than-peer leverage capital, and substantial reserves for loan losses. OTS examiners did not question whether the ongoing trend of high growth and concentrations in subprime loans and residual interest securities was a prudent strategy for the bank. Consequently, the CAMELS ratings did not accurately reflect the conditions of those components.

Superior's business strategy as a lender to high-risk borrowers was clearly visible in data that the OTS prepared comparing it to other thrifts of comparable size. Superior's ratio of nonperforming assets to total assets in December 1998 was 233 percent higher than the peer group's median. Another indicator of risk was the interest rate on the mortgages that Superior had made with a higher rate indicating a

[9] Section 211, Asset Quality—Loan Portfolio Diversification, OTS Regulatory Handbook, January 1994.

riskier borrower. In 1999, over 39 percent of Superior's mortgages carried interest rates of 11 percent or higher. Among Superior's peer group, less than 1 percent of all mortgages had interest rates that high.

OTS's 1997 examination report for Superior Bank illustrated the influence of Superior's high earnings on the regulator's assessment. The 1997 examination report noted that Superior's earnings were very strong and exceeded industry averages. The report stated that the earnings were largely the result of large imputed gains from the sale of loans with high interest rates and had not been realized on a cashflow basis. Furthermore, the report recognized that changes in prepayment assumptions could negatively impact the realization of the gains previously recognized. Despite the recognition of the dependence of Superior's earnings on critical assumptions regarding prepayment and actual loss rates, OTS gave Superior Bank the highest composite CAMELS rating, as well as the highest rating for four of the six CAMELS components—asset quality, management, earnings, and sensitivity to market risk—at the conclusion of its 1997 examination.

OTS Relied on Superior's Management and Owners

OTS consistently assumed that Superior's management had the necessary expertise to safely manage the complexities of Superior's securitization activities. In addition, OTS relied on Superior's management to take the necessary corrective actions to address the deficiencies that had been identified by OTS examiners. Moreover, OTS expected the owners of Superior to come to the bank's financial rescue if necessary. These critical assumptions by OTS ultimately proved erroneous.

From 1993 through 1999, OTS appeared to have had confidence in Superior's management's ability to safely manage and control the risks associated with its highly sophisticated securitization activities. As an illustration of OTS reliance on Superior's management assurances, OTS examiners brought to management's attention in the 1997 and 1999 examinations underlying mortgage pools had prepayment rates exceeding those used in revaluation. OTS examiners accepted management's response that the prepayment rates observed on those subpools were abnormally high when compared with historical experience, and that they believed sufficient valuation allowances had been established on the residuals to prevent any significant changes to capital. It was not until the 2000 examination, when OTS examiners demanded supporting documentation concerning residual interests, that they were surprised to learn that such documentation was not always available. OTS's optimistic assessment of the capability of Superior's management continued through 1999. For example, OTS noted in its 1999 examination report that the weaknesses it had detected during the examination were well within the board of directors' and management's capabilities to correct.

OTS relied on Superior Bank's management and board of directors to take the necessary corrective action to address the numerous deficiencies OTS examiners identified during the 1993 through 1999 examinations. However, many of the deficiencies remained uncorrected even after repeated examinations. For example, OTS expressed concerns in its 1994 and 1995 examinations about the improper inclusion of reserves for the residual interest assets in the Allowance for Loan and Lease Losses. This practice had the net effect of overstating the institution's total capital ratio. OTS apparently relied on management's assurances that they would take the appropriate corrective action, because this issue was not discussed in OTS's 1996, 1997, or 1999 examination reports. However, OTS discovered in its 2000 examination that Superior Bank had not taken the agreed-upon corrective action, but in fact had continued the practice. Similarly, OTS found in both its 1997 and 1999 examinations that Superior was underreporting classified or troubled loans in its Thrift Financial Reports (TFR). In the 1997 examination, OTS found that not all classified assets were reported in the TFR and obtained management's agreement to ensure the accuracy of subsequent reports. In the 1999 examination, however, OTS found that $43.7 million in troubled assets had been shown as repossessions on the most recent TFR, although a significant portion of these assets were accorded a "loss" classification in internal reports. As a result, actual repossessions were only $8.4 million. OTS conducted a special field visit to examine the auto loan operations in October 1999, but the review focused on the classification aspect rather than the fact that management had not been very conservative in charging-off problem auto credits, as FDIC had pointed out.

OTS also appeared to have assumed that the wealthy owners of Superior Bank would come to the bank's financial rescue when needed. The 2000 examination report demonstrated OTS's attitude toward its supervision of Superior by stating that failure was not likely due to the institution's overall strength and financial capacity and the support of the two ownership interests comprised of the Alvin Dworman and Jay Pritzker families.

OTS's assumptions about the willingness of Superior's owners not to allow the institution to fail were ultimately proven false during the 2001 negotiations to recapitalize the institution. As a result, the institution was placed into receivership.

OTS Placed Undue Reliance on the External Auditors

OTS also relied on the external auditors and others who were reporting satisfaction with Superior's valuation method. In previous reports, GAO has supported having examiners place greater reliance on the work of external auditors in order to enhance supervisory monitoring of banks. Some regulatory officials have said that examiners may be able to use external auditors' work to eliminate certain examination procedures from their examinations—for example, verification or confirmation of the existence and valuation of institution assets such as loans, derivative transactions, and accounts receivable. The officials further said that external auditors perform these verifications or confirmations routinely as a part of their financial statement audits. But examiners rarely perform such, verifications because they are costly and time consuming.

GAO continues to believe that examiners should use external auditors' work to enhance the efficiency of examinations. However, this reliance should be predicated on the examiners' obtaining reasonable assurance that the audits have been performed in a quality manner and in accordance with professional standards. OTS's Regulatory Handbook recognizes the limitations of examiners' reliance on external auditors,[10] noting that examiners "may" rely on an external auditor's findings in low-risk areas. However, examiners are expected to conduct more in-depth reviews of the external auditor's work in high-risk areas. The handbook also suggests that a review of the auditor's workpapers documenting the assumptions and methodologies used by the institution to value key assets could assist examiners in performing their examinations.

In the case of Superior Bank the external auditor, Ernst & Young, one of the "Big Five" accounting firms,[11] provided unqualified opinions on the bank's financial statements for years. In a January 2000 meeting with Superior Bank's Audit Committee to report the audit results for the fiscal year ending June 30, 1999, Ernst & Young noted that "after running their own model to test the Bank's model, Ernst & Young believes that the overall book values of financial receivables as recorded by the Bank are reasonable considering the Bank's overall conservative assumptions and methods." Not only did Ernst & Young not detect the overvaluation of Superior's residual interests, the firm explicitly supported an incorrect valuation until, at the insistence of the regulators, the Ernst & Young office that had conducted the audit sought a review of its position on the valuation by its national office. Ultimately, it was the incorrect valuation of these assets that led to the failure of Superior Bank. Although the regulators recognized this problem before Ernst & Young, they did not do so until the problem was so severe the bank's failure was inevitable.

Although FDIC Was First To Raise Concerns About Superior, Problems Could Have Been Detected Sooner

FDIC raised serious concerns about Superior's operations at the end of 1998 based on its off-site monitoring and asked that an FDIC examiner participate in the examination of the bank that was scheduled to start in January 1999. At that time, OTS rated the institution a composite "1". Although FDIC's 1998 off-site analysis began the identification of the problems that led to Superior's failure, FDIC had conducted similar off-site monitoring in previous years that did not raise concerns.

During the late 1980's and early 1990's, FDIC examined Superior Bank several times because it was operating under an assistance agreement with FSLIC. However, once Superior's condition stabilized and its composite rating was upgraded to a "2" in 1993, FDIC's review was limited to off-site monitoring. In 1995, 1996, and 1997, FDIC reviewed the annual OTS examinations and other material, including the banks supervisory filings and audited financial statements. Although FDIC's internal reports noted that Superior's holdings of residual assets exceeded its capital, they did not identify these holdings as concerns.

FDIC's interest in Superior Bank was heightened in December 1998 when it conducted an off-site review, based on September 30, 1998 financial information. During this review, FDIC noted—with alarm—that Superior Bank exhibited a high-risk asset structure. Specifically, the review noted that Superior had significant investments in the residual values of securitized loans. These investments, by then, were equal to roughly 150 percent of its Tier 1 capital. The review also noted that signifi-

[10] Section 350, Independent Audit, OTS Regulatory Handbook, January 1994.

[11] The "Big Five" accounting firms are Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP.

cant reporting differences existed between the bank's audit report and its quarterly financial statement to regulators, that the bank was a subprime lender, and had substantial off-balance sheet recourse exposure.

As noted earlier, however, the bank's residual assets had been over 100 percent of capital since 1995. FDIC had been aware of this high concentration and had noted it in the summary analyses of examination reports that it completed during off-site monitoring, but FDIC did not initiate any additional off-site activities or raise any concerns to OTS until after a 1998 off-site review that it performed. Although current guidance would have imposed limits at 25 percent, there was no explicit direction to the bank's examiners or analysts on safe limits for residual assets. However, Superior was clearly an outlier, with holdings substantially greater than peer group banks.

In early 1999, FDIC's additional off-site monitoring and review of OTS's January 1999 examination report—in which OTS rated Superior a "2"—generated additional concerns. As a result, FDIC officially downgraded the bank to a composite "3" in May 1999, triggering higher deposit insurance premiums under the risk-related premium system. According to FDIC and OTS officials, FDIC participated fully in the oversight of Superior after this point.

Poor OTS–FDIC Communication Hindered a Coordinated Supervisory Strategy

Communication between OTS and FDIC related to Superior Bank was a problem. Although the agencies worked together effectively on enforcement actions (discussed below), poor communication seems to have hindered coordination of supervisory strategies for the bank.

The policy regarding FDIC's participation in examinations led by other Federal supervisory agencies was based on the "anticipated benefit to FDIC in its deposit insurer role and risk of failure the involved institution poses to the insurance fund."[12] This policy stated that any back-up examination activities must be "consistent with FDIC's prior commitments to reduce costs to the industry, reduce burden, and eliminate duplication of efforts."

In 1995, OTS delegated to its regional directors the authority to approve requests by FDIC to participate OTS examinations.[13] The memorandum from OTS headquarters to the regional directors on the FDIC participation process states that:

> "The FDIC's written request should demonstrate that the institution represents a potential or likely failure within a 1 year time frame, or that there is a basis for believing that the institution represents a greater than normal risk to the insurance fund and data available from other sources is insufficient to assess that risk."

As testimony before this Committee last fall documented, FDIC's off-site review in 1998 was the first time that serious questions had been raised about Superior Bank's strategy and finances. As FDIC Director John Reich testified,

> "The FDIC's off-site review noted significant reporting differences between the bank's audit report and its quarterly financial statement to regulators, increasing levels of high-risk, subprime assets, and growth in retained interests and mortgage servicing assets."[14]

Because of these concerns, FDIC regional staff called OTS regional staff and discussed having an FDIC examiner participate in the January 1999 examination of Superior Bank. OTS officials, according to internal e-mails, were unsure if they should agree to FDIC's participation. Ongoing litigation between FDIC and Superior and concern that Superior's "poor opinion" of FDIC would "jeopardize [OTS's] working relationship" with Superior were among the concerns expressed in the e-mails. OTS decided to wait for a formal, written FDIC request to see if it "convey[ed] a good reason" for wanting to join in the OTS examination.

OTS and FDIC disagree on what happened next. FDIC officials told us that they sent a formal request to the OTS regional office asking that one examiner participate in the next scheduled examination but did not receive any response. OTS offi-

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[12] Each Federal banking agency is responsible for conducting examinations of the depository institutions under its jurisdiction. FDIC is the Federal banking regulator responsible for examining Federally insured State-chartered banks that are not members of the Federal Reserve System. In addition, FDIC may conduct a special examination of any insured depository institution whenever the FDIC's Board of Directors decides that the examination is necessary to determine the condition of the institution for insurance purposes. 12 U.S.C. § 1820(b) (2000).

[13] OTS Memorandum to Regional Directors from John F. Downey, Director of Supervision, Regarding FDIC Participation on Examinations, April 5, 1995.

[14] Statement of John Reich, Acting Director, Federal Deposit Insurance Corporation, on the Failure of Superior Bank, FSB, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 11, 2001.

cials told us that they never received any formal request. FDIC files do contain a letter, but there is no way to determine if it was sent or lost in transit. This letter, dated December 28, 1998, noted areas of concern as well as an acknowledgment that Superior's management was well regarded, and that the bank was extremely profitable and considered to be "well-capitalized."

OTS did not allow FDIC to join their exam, but did allow its examiners to review work papers prepared by OTS examiners. Again, the two agencies disagree on the effectiveness of this approach. FDIC's regional staff has noted that in their view this arrangement was not satisfactory, since their access to the workpapers was not sufficiently timely to enable them to understand Superior's operations. OTS officials told us that FDIC did not express any concerns with the arrangement and were surprised to receive a draft memorandum from FDIC's regional office proposing that Superior's composite rating be lowered to a "3," in contrast to the OTS region's proposed rating of "2."

However, by September 1999, the two agencies had agreed that FDIC would participate in the next examination, scheduled for January 2000.

In the aftermath of Superior's failure and the earlier failure of Keystone National Bank, both OTS and FDIC have participated in an interagency process to clarify FDIC's role, responsibility, and authority to participate in examinations as the "backup" regulator. In both bank failures, FDIC had asked to participate in examinations, but the lead regulatory agency (OTS in the case of Superior and the Office of the Comptroller of the Currency in the case of Keystone) denied the request. On January 29, 2002, FDIC announced an interagency agreement that gives it more authority to enter banks supervised by other regulators.

While this interagency effort should lead to a clearer understanding among the Federal bank supervisory agencies about FDIC's participation in the examinations of and supervisory actions taken at open banks, it is important to recognize that at the time that FDIC asked to join in the 1999 examination of Superior Bank, there were policies in place that should have guided its request and OTS's decision on FDIC's participation. As such, how the new procedures are implemented is a critical issue. Ultimately, coordination and cooperation among Federal bank supervisors depend on communication among these agencies, and miscommunication plagued OTS and FDIC at a time when the two agencies were just beginning to recognize the problems that they confronted at Superior Bank.

The Effectiveness of Enforcement Actions Was Limited

As a consequence of the delayed recognition of problems at Superior Bank, enforcement actions were not successful in containing the loss to the deposit insurance fund. Once the problems at Superior Bank had been identified, OTS took a number of formal enforcement actions against Superior Bank starting on July 5, 2000. These actions included a PCA directive.

There is no way to know if earlier detection of the problem at Superior Bank, particularly the incorrect valuation of the residual assets, would have prevented the bank's ultimate failure. However, earlier detection would likely have triggered enforcement actions that could have limited Superior's growth and asset concentration and, as a result, the magnitude of the loss to the insurance fund.

Table 1 describes the formal enforcement actions. (Informal enforcement actions before July 2000 included identifying "actions requiring board attention" in the examination reports, including the report dated January 24, 2000.) The first action, the "Part 570 Safety and Soundness Action,"[15] followed the completion of an on-site examination that began in January 2000, with FDIC participation. That formally notified Superior's Board of Directors of deficiencies and required that the board take several actions, including:

- Developing procedures to analyze the valuation of the bank's residual interests, including obtaining periodic independent valuations;
- Developing a plan to reduce the level of residual interests to 100 percent of the bank's Tier 1 or core capital within 1 year;
- Addressing issues regarding the bank's automobile loan program; and
- Revising the bank's policy for allowances for loan losses and maintaining adequate allowances.

On July 7, 2000, OTS also officially notified Superior that it had been designated a "problem institution." This designation placed restrictions on the institution, including on asset growth. Superior Bank submitted a compliance plan, as required,

[15] 12 C.F.R. Part 570.

on August 4, 2000.[16] Due to the amount of time that Superior and OTS took in negotiating the actions required, this plan was never implemented, but it did serve to get Superior to cease its securitization activities.

Table 1: Enforcement Actions Taken by OTS Against Superior Bank or its Holding Companies

Date	Type of enforcement action	Key provisions of the action
July 5, 2000	Part 570 Safety and Soundness	Develop and implement a compliance plan to limit asset concentration in residual interests to 100 percent of core capital.
February 12, 2001	Prompt Corrective Action Notice	Develop a capital plan by March 14, 2001, intended to bring capital up to the adequately capitalized level.
February 14, 2001	Prompt Corrective Action Directive	Prohibit asset growth and require weekly sales of all loans originated during the previous week.
February 14, 2001	Consent Orders to Cease and Desist for Affirmative Relief	Implement modifications to the loan purchases between the holding companies and Superior.
February 14, 2001	Consent Orders to Cease and Desist for Affirmative Relief	Require holding companies to establish escrow accounts at Superior Bank and deposit sums equal to two times the aggregate amount of any loss reasonably projected on the sale of all loans originated.
May 24, 2001	Prompt Corrective Action Directive	Requires Superior to increase its capital—condition imposed in writing in connection with the approval of its capital plan.
May 24, 2001	Stipulation and Consent to Individual Minimum Capital Requirement	Modify capital requirements to allow Superior to hold less capital than established under Prompt Corrective Action.

Source: OTS.

While Superior and OTS were negotiating over the Part 570 plan, Superior adjusted the value of its residual interests with a $270 million write-down. This, in turn, led to the bank's capital level falling to the "significantly undercapitalized" category, triggering a PCA directive that OTS issued on February 14, 2001.[17]

The PCA directive required the bank to submit a capital restoration plan by March 14, 2001.[18] Superior Bank, now with new management, submitted a plan on that date, that, after several amendments (detailed in the chronology in Appendix I), OTS accepted on May 24, 2001. That plan called for reducing the bank's exposure to its residual interests and recapitalizing the bank with a $270 million infusion from the owners. On Ju1y 16, 2001, however, the Pritzker interests, one of the two ultimate owners of Superior Bank, advised OTS that they did not believe that the capital plan would work and therefore withdrew their support. When efforts to change their position failed, OTS appointed FDIC as conservator and receiver of Superior.

Although a PCA directive was issued when the bank became "significantly undercapitalized," losses to the deposit insurance fund were still substantial. The reasons for this are related to the design of PCA itself. First, under PCA, capital is a key factor in determining an institution's condition. Superior's capital did not fall to the "significantly undercapitalized" level until it corrected its flawed valuation of its residual interests. Incorrect, financial reporting, such as was the case with Superior Bank, will limit the effectiveness of PCA because such reporting limits the regulators' ability to accurately measure capital.

Second, PCA's current test for "critically undercapitalized," is based on the tangible equity capital ratio, which does not use a risk-based capital measure. Thus it only includes on-balance sheet assets and does not fully encompass off-balance sheet risks, such as those presented in an institution's securitization activities. Therefore, an institution might become undercapitalized using the risk-based capital ratio but would not fall into the "critically undercapitalized" PCA category under the current capital measure.

Finally, as GAO has previously reported, capital is a lagging indicator, since an institution's capital does not typically begin to decline until it has experienced substantial deterioration in other components of its operations and finances. As noted by OTS in its comments on our 1996 report:

> "PCA is tied to capital levels and capital is a lagging indicator of financial problems. It is important that regulators continue to use other supervisory

[16] In response to OTS requests on September 1 and October 27, 2000, Superior's board provided additional information on September 29 and November 13, 2000.

[17] Section 38 of the Federal Deposit Insurance Act authorizes PCA directives when a bank's capital falls below defined levels. In an effort to resolve a bank's problems at the least cost to the insurance fund, Section 38 provides that supervisory actions be taken and certain mandatory restrictions be imposed on the bank (12 U.S.C. § 1831o)

[18] On February 14, 2001, OTS also issued two consent orders against Superior's holding companies.

and enforcement tools, to stop unsafe and unsound practices before they result in losses, reduced capital levels, or failure."[19]

Further, PCA implicitly contemplates that a bank's deteriorating condition and capital would take place over time. In some cases, problems materialize rapidly, or as in Superior's case, long-developing problems are identified suddenly. In such cases, PCA's requirements for a bank plan to address the problems can potentially delay other more effective actions.

It is worth noting that while Section 38 uses capital as a key factor in determining an institution's condition, Section 39 gives Federal regulators the authority to establish safety and soundness related management and operational standards that do not rely on capital, but could be used to bring corrective actions before problems reach the capital account.

Similar Problems Had Occurred in Some Previous Bank Failures

The failure of Superior Bank illustrates the possible consequences when banking supervisors do not recognize that a bank has a particularly complex and risky portfolio. Several other recent failures provide a warning that the problems seen in the examination and supervision of Superior Bank can exist elsewhere. Three other banks, BestBank, Keystone Bank, and Pacific Thrift and Loan (PTL), failed and had characteristics that were similar in important aspects to Superior. These failures involved FDIC (PTL and BestBank) and the Office of the Comptroller of the Currency (Keystone).

BestBank was a Colorado bank that closed in 1998, costing the insurance fund approximately $172 million. Like Superior, it had a business strategy to target subprime borrowers, who had high delinquency rates. BestBank in turn reported substantial gains from these transactions in the form of fee income. The bank had to close because it falsified its accounting records regarding delinquency rates and subsequently was unable to absorb the estimated losses from these delinquencies.

Keystone, a West Virginia bank, failed in 1999, costing the insurance fund approximately $800 million. While fraud committed by the bank management was the most important cause of its failure, Keystone's business strategy was similar to Superior's and led to some similar problems. In 1993, Keystone began purchasing and securitizing Federal Housing Authority Title I Home improvement Loans that were originated throughout the country. These subprime loans targeted highly leveraged borrowers with little or no collateral. The securitization of subprime loans became Keystone's main line of business and contributed greatly to its apparent profitability. The examiners, however, found that Keystone did not record its residual interests in these securitizations until September 1997, several months after SFAS No. 125 took effect. Furthermore, examiners found the residual valuation model deficient, and Keystone had an unsafe concentration of mortgage products.

PTL was a California bank that failed in 1999, costing the insurance fund approximately $52 million. Like Superior Bank PTL entered the securitization market by originating loans for sale to third-party securitizing entities. While PTL enjoyed high asset and capital growth rates, valuation was an issue. Also, similar to Superior Bank, the examiners overrelied on external auditors in the PTL case. According to the material loss review, Ernst & Young, PTL's accountant, used assumptions that were unsupported and optimistic.

[19] Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions, Nov. 1996, GAO/GGD–97–18, page 71.

Appendix I: Summary of Key Events Associated with the Failure of Superior Bank

An abbreviated chronology of key events is described in table 1 below. Some details have been left out to simplify what is a more complicated story. Readers should also keep in mind that ongoing investigations are likely to provide additional details at a later date.

Table 1: Summary of Key Events Associated with the Failure of Superior Bank

Date	Event
December 1988	Superior Bank was formed through the acquisition of Lyons Savings. The Pritzker and Dworman families purchase troubled Lyons Saving in a Federal Savings and Loan Insurance Corporation (FSLIC) assisted transaction.
1989 - 1997	The Office of Thrift Supervision (OTS) rated Superior Bank a composite "3" in 1989 and upgraded it to a "2" in 1991. OTS' rating stayed at that level until it was upgraded to a "1" in 1997. The Federal Deposit Insurance Corporation (FDIC) performed concurrent examinations of Superior and gradually upgraded Superior's composite rating from a "4" in 1990 to a "3" in 1991 and 1992 and to "2" in 1993. When Superior's condition stabilized in 1993, FDIC began relying primarily on off-site monitoring.
June 1992	Superior payed its first dividend, $1.5 million in cash, to its holding company, Coast-to-Coast Financial Holdings. The dividend represented 78 percent of net earnings for the fiscal year ending June 30, 1992. From 1992 through 2000, Superior paid out approximately $200.8 million in dividends ($169.7 million in cash and $31.1 million in financial receivables) to its holding companies.
December 1992	Superior Bank acquired Alliance Funding Company, a large-scale mortgage banking company. Alliance Funding Company's focus was on low credit quality home equity (subprime) lending, which became the core of Superior Bank's operations.
March 1993	Superior Bank executed its first securitization of subprime mortgage loans for the secondary market and began booking residual interests on its balance sheet.
July 1993	OTS examination identified concerns with Superior's mortgage banking operations, including increasing levels of excess mortgage servicing rights which had a higher level of risk than traditional investments and non-conforming loans involve a higher level of risk than traditional lending.
June 1994	OTS examination reported that Superior's mortgage banking operation, and the continued investment in the residual interests originated by Superior, exposed the institution to a somewhat greater risk than normal.
1995	Superior created an auto lending division with plans to securitize and sell the loans in a manner similar to the mortgage loans.
October 1995	OTS examination disclosed a potential concern with the level of residual interests in Superior's inventory. As of June 30, 1995, residual interests comprised 100 percent of core capital.
October 1995	OTS examination disclosed that a $2.6 million reserve established to protect the residual interests from the changing business cycle was improperly counted toward risk-based capital. OTS Regulatory Plan noted that the removal of this reserve from the capital calculation could result in Superior Bank's falling below the threshold for well-capitalized institutions.
December 1995	OTS Regulatory Plan noted that residual interests totaled $108 million representing roughly 142 percent of core capital as of December 31, 1995. The regulatory plan stated that this concentration posed a risk to capital since accelerated repayment of the underlying loans—due to a downward movement of interest rates or other reasons—would cause a downward valuation of the residual interests.
October 1996	OTS examination concluded that the residual interests were adequately valued.
October 1997	OTS examination of Superior upgraded the composite rating to a "1". The Report of Examination noted that this review disclosed no concerns with management's calculations on the gains from the sale of loans and the resulting imputed financial receivables.
September 1998	FDIC performs an off-site review of Superior Bank using the Thrift Financial Reports and the audited financial statements as of June 30, 1998. FDIC concluded that (1) while Superior had not been identified as a "subprime" lender in the past, interest rates exhibited by its current held-for-sale loan portfolio were characteristic of such portfolios; (2) Superior exhibited a high-risk asset structure due to its significant investments in the residual values of the securitization of loans and held for sale loans that exhibited interest rates that were substantially higher than peer; and (3) Superior had substantial recourse exposure in loans "sold" through its securitization program.

Date	Event
December 1998	FDIC wrote a request to the OTS regional director requesting FDIC participation in the upcoming January 1999 OTS examination. The letter stated the key findings of the off-site review and requested FDIC's participation in the upcoming exam "to better understand the potential risk Superior's operations may represent to the FDIC insurance fund."
January 1999	OTS regional director and assistant regional director verbally denied FDIC's request to participate in the exam. Their rationale was that Superior was rated a composite "1" at its last examination and it was not the regular practice of FDIC to participate in OTS exams of thrifts with such ratings. In addition, they raised concerns over possible negative perceptions an on-site FDIC presence might cause due to litigation between Superior and FDIC.
March 1999	OTS completed safety and soundness examination and downgraded Superior to a composite rating of "2." The Report of Examination identified two items requiring action by Superior's Board of Directors. The first item involved problems with the asset classification and the allowance for loans and lease losses. The second item involved the need to establish adequate procedures to analyze the ongoing value of the financial receivables and servicing rights related to auto loans and that the book value of these assets be adjusted in accordance with FAS 125. The exam also concluded that the valuations of the residual interests, which represented 167 percent of tangible capital as of December 31, 1998, were reasonable.
May 1999	FDIC lowered Superior's composite rating to a "3" on the basis of off-site monitoring and the OTS 1999 examination. In June 1999, FDIC sent a memorandum to the OTS regional director stating that a composite rating of "3" was more appropriate and reflective of the overall risk inherent in Superior. The memorandum stated that "off-site analysis of the following conditions and ongoing trends lead us to believe that Superior's current risk profile is unacceptably high relative to the protection offered by its capital position. Some of these trends and conditions include: (a) high growth/concentrations in residual value mortgage securities and loan servicing assets; (b) substantial growth/concentrations in high-coupon (about 250 basis points higher than peer) mortgage loans sold with recourse; (c) substantial concentrations in "high-coupon" on-balance sheet mortgage loans; (d) explosive growth in high coupon (900 basis points more than peer) auto loans that has resulted in a concentration exceeding T1 capital; (e) an increase in repossessed assets (mostly autos) to about 20% of T1 capital, with the majority classified doubtful or loss by the OTS; and unusual regulatory reporting that reflects residual securities reserves in the general ALLL."
September 1999	FDIC sent a formal request to OTS requesting participation in the 2000 examination. FDIC received written concurrence from OTS on September 24, 1999.
October 1999	OTS conducted a field visit to review the 1999 examination findings of deficiencies in management reporting of classified assets and the apparent continued reporting deficiencies in two subsequent regulatory reports.
May 2000	OTS and FDIC completed a joint exam of Superior (as of 1/24/00) and assigned a composite rating of "4." The exam described the need for a number of corrective actions including the need for Superior to obtain an "independent valuation of the financial receivables related to the 1998-1 and 1999-1 securitizations from a third party source in order to validate the results produced by the internal model."
July 2000	OTS issued a Notice of Deficiency and Requirements for Submission of a Part 570 Safety and Soundness Compliance Plan letter to Superior Bank. Superior was required to submit an acceptable Safety and Soundness Compliance Plan (Corrective Plan) by August 4, 2000. Among other things, the corrective plan was to provide for the development and implementation of procedures for analyzing the fair market value of the residual interests and auto financial receivables and adjusting the book value of these assets in accordance with FAS No.115. Superior's corrective plan was also to address credit underwriting, concentration of credit risk, and Allowance for Loan and Lease Losses issues. As part of the 570 enforcement action, the bank was required to reduce its level of financial receivables and related assets to no greater than 100 percent of Tier 1 capital within a year.
October 2000	OTS and FDIC conducted a joint field visit to determine management's compliance with promised corrective actions from the earlier on-site examination. The field visit report concluded that Superior's financial statements were not fairly stated at the most recent audit date of June 30, 2000, due to incorrect accounting for the financial receivables and overcollateralization assets, which resulted in inflated book entries on the balance sheet for the respective assets, earnings and capital. The examiners also concluded that the most recent audit report, prepared by Ernst & Young as of June 30, 2000, should be rejected and that the audit report should be restated

Date	Event
	to reflect the adjustments resulting from the field visit.
February 2001	Ernst & Young agrees with the regulators that the accounting for the financial receivables and overcollateralization assets were incorrect.
February 2001	OTS determined that Superior Bank was significantly undercapitalized on or before December 31, 2000, as a result of adjustments from the January 2000 exam and October 2000 field visit. OTS issued a PCA Directive that required the bank to submit a capital restoration plan by March 14, 2001. OTS terminated its review of the institution's Part 570 corrective plan as a result of the issuance of the PCA directive. OTS also issued two Consent Orders to Cease and Desist for Affirmative Relief against Superior's holding companies (Coast-to-Coast Financial Corporation and Superior Holding, Inc.). One was issued to implement modifications to the loan purchases between the holding companies and Superior "in order to eliminate losses experienced by the Savings Bank within the lending program." The other order required the holding companies to establish an escrow account at Superior Bank and deposit sums "equal to two times the aggregate amount of any loss the Savings Bank reasonably projects it will incur on the sale of all loans originated by the Savings Bank during the current calendar week, or $5 million, whichever is greater."
March 2001	Superior Bank and Ernst & Young completed a revaluation for all the financial receivables and overcollateralization assets using the correct accounting methodology and calculating from the inception date of each securitization pool. The recalculation resulted in a required write-down of the financial receivables and overcollateralization assets totaling $270 million. On March 2, 2001, Superior amended its December 31, 2000, TFR to reflect the correct fair market value of the F/R and O/C assets. OTS performed an off-site examination of Superior Bank and downgrades its composite rating to a "5."
May 2001	OTS conditionally approved Superior Bank's amended capital restoration plan (plan initiated submitted by Superior on March 14, 2001, and amended on April 30, May 15, and May 18, including revisions received by OTS on May 19 and May 21) and issued a Prompt Corrective Action Directive requiring the bank to increase its capital levels by complying with the terms of the capital restoration plan.
July 2001	A $150 million write-down of the residual interests was necessitated by overly optimistic assumptions used in Superior's valuation model.
July 2001	Pritzker interests sent a letter to OTS indicating that the plan will not work and OTS closed Superior Bank, FSB, and placed the bank under conservatorship of FDIC.
December 2001	FDIC and OTS reached a resolution with the holding companies of Superior Bank on "all matters arising out of the operation and failure of Superior Bank. Under the terms of the agreement, the Superior holding companies and their owners (the Pritzker and Dworman interests) admit no liability and agreed to pay the FDIC $460 million and other consideration."

MATERIAL LOSS REVIEW OF SUPERIOR BANK, FSB

OIG-02-040 February 6, 2002

Office of Inspector General

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The Department of the Treasury

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Abbreviations

AFC	Alliance Funding Company
ALLL	Allowance for Loan and Lease Losses
CCFC	Coast-To-Coast Financial Corporation
CFR	Code of Federal Regulations

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Abbreviations continued

DOS	Division of Supervision
DRR	Division of Resolutions and Receiverships
FAS	Financial Accounting Standards
FASB	Financial Accounting Standards Board
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FR	Financial Receivable
FSB	Federal Savings Bank
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
IMCR	Individual Minimum Capital Requirement
OC	Overcollateralization
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
SAIF	Savings Association Insurance Fund
SHI	Superior Holding Incorporated
TFR	Thrift Financial Report
USC	United States Code

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

February 6, 2002

James E. Gilleran
Director
Office of Thrift Supervision

As mandated under section 38(k) of the Federal Deposit Insurance Act (FDIA), we reviewed the failure of Superior Bank, FSB (Superior) of Oakbrook Terrace, Illinois. On July 27, 2001, the Office of Thrift Supervision (OTS) declared Superior insolvent after its principal owners failed to implement a Capital Restoration Plan (capital plan) that would have, in part, required a cash infusion of $270 million. In December 2001, the Federal Deposit Insurance Corporation (FDIC) estimated that Superior's failure would cost the Savings Association Insurance Fund (SAIF) $350 million.

The FDIA-mandated review essentially requires us to (1) ascertain the cause(s) of Superior's failure; (2) assess OTS' supervision of Superior; and (3) where applicable, recommend how such failures might be avoided in the future. We conducted detailed fieldwork at OTS headquarters in Washington, D.C., and OTS' regional office in Chicago, Illinois. We also met with FDIC's Division of Supervision (DOS) supervisory officials in Chicago, Illinois, and FDIC's Division of Resolutions and Receiverships (DRR) and Division of Finance (DOF) in Dallas, Texas. We reviewed the supervisory files and interviewed key supervisory officials, such as examiners and others involved in regulatory enforcement matters.

Although this report largely addresses the three FDIA-mandated areas of review, we were unable to fully assess certain aspects of OTS' supervision of Superior. This is due, in part, to delays by OTS in providing us with documents it obtained through 24

subpoenas issued after July 27, 2001. We intend to continue reviewing these documents, and issue a subsequent report should any material findings arise from that review. A detailed discussion of the review objectives, scope, and methodology is provided in Appendix 1.

Results in Brief

Superior was originally established in 1988 when the Pritzker and Dworman interests acquired Lyons Savings Bank of Countryside, Illinois. Renamed Superior in 1989, the acquisition entailed an investment of $42.5 million and assistance by the former Federal Savings and Loan Insurance Corporation (FSLIC). The corporate structure consisted of Superior being wholly owned by Coast-To-Coast Financial Corporation (CCFC), the holding company, with the Pritzker and Dworman interests each owning 50 percent of the holding company. At the time of its closing in July 2001, Superior had just over $1.9 billion in recorded assets, which had been largely funded through FDIC insured deposits of about $1.5 billion.

Beginning in 1993, Superior embarked on a business strategy marked by rapid and aggressive growth into subprime[1] home mortgages and automobile loans. Superior transferred the loans to a third party, who then sold "asset-backed securities" to investors. The repayment of these securities was supported by the expected proceeds from the underlying subprime loans. For Superior, the securitization of subprime loans created what is referred to as a residual asset arising from the sold securities and a portion of the loan proceeds that were to flow back to Superior. Securitization of subprime loans generated large non-cash profits and overstated capital levels due to applicable accounting conventions at the time.[2] Along with profitability came rapid growth. Superior more

[1] "Subprime lending" generally refers to extending credit to borrowers exhibiting significantly higher credit risk than prime borrowers.

[2] Issued in June 1996, Financial Accounting Standard (FAS) No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* provided for the immediate recognition of a gain or loss on the sale on the date of the transaction (known as "gain-on-sale accounting"). FAS No. 125 also permitted the recording of the anticipated future income derived from the residual assets as capital.

than doubled in asset size from about $974 million in 1993 to $2.3 billion in 2001.

Properly valuing and recording the residual assets were critical thrift management judgments. It largely depended on management's ability to accurately estimate several factors affecting the underlying residual assets' cash flows, such as default rates (credit risk) and loan prepayments. Superior's large non-cash earnings generated from the subprime loan securitizations likely masked, for a period of time, its actual losses caused by flawed valuation assumptions and calculations. Superior also assumed credit losses when the actual cash flows from the underlying loans were less than estimated. Eventually Superior had to make significant write-downs of the residual assets. Appendix 2 provides a graphical description of Superior's securitization of subprime loans and the resulting creation of residual assets.

On December 10, 2001, Federal regulators and the Pritzker and Dworman interests entered into a settlement, which provided for them to eventually pay FDIC $460 million. As of December 31, 2001, the FDIC adjusted the estimated cost of Superior's failure to $350 million taking into account the settlement. This also factors in the financial impact of several resolution transactions, such as asset sales that FDIC had completed and planned.

Causes of Superior's Failure

The events precipitating Superior's insolvency in July 2001 were essentially a series of accounting adjustments resulting in losses and capital depletion. When the principal owners failed to implement the capital plan that would have entailed a capital infusion of $270 million and removal of substantially all of the $841.8 million in residual assets from the thrift's books, OTS deemed Superior equity insolvent by $125.6 million.[3] The accounting adjustments were necessitated after OTS and FDIC examiners determined that Superior needed to write-off a $36.7 million receivable from the holding company, and had overstated

[3] Adjusted Tier 1 (Core) Capital was a negative $201.9 million after the disallowance of combined deferred tax and servicing assets of $76.3 million.

the value of residual assets by $150 million. Contributing to the negative capital position were continued operating losses resulting from loan originations and discontinued business operations.

While the immediate causes of Superior's insolvency in 2001 appear to be improper accounting and inflated valuations of residual assets, the root causes of the thrift's failure could be attributed to a confluence of factors going back as early as 1993. Indeed, we believe that Superior exhibited many of the same red flags identified with problem banks of the 1980s and early 1990s. These included (1) asset concentration, arguably the most dominant factor to Superior's failure, (2) rapid growth into a new high-risk activity, (3) deficient risk management systems relative to validation issues, (4) liberal underwriting of subprime loans, (5) unreliable loan loss provisioning, (6) economic factors affecting asset value, and (7) non-responsive management to supervisory concerns.

OTS' Supervision of Superior

In the early years, much of OTS' supervision of Superior appeared incongruous with the institution's increasing risk profile since 1993. It was not until 2000 that OTS expanded examination coverage of residual assets and started meaningful enforcement actions. By then, however, it was arguably too late given Superior's high level of, and concentration in residual assets. At times, certain aspects of OTS examinations lacked sufficient supervisory skepticism, neglecting the increasing risks posed by the mounting concentration in residual assets. OTS' enforcement response also proved to be too little and too late to curb the increasing risk exposure, and at times exhibited signs of forbearance. We believe that it was basically Superior's huge residual assets concentration and OTS' delayed examination coverage of residual assets valuations that primarily negated the early supervisory intervention provisions of Prompt Corrective Action (PCA).[4]

[4] PCA is a framework of supervisory actions under 12 United States Code (USC) §1831o for insured thrifts that are not adequately capitalized. These actions become increasingly severe as a thrift falls into lower capital categories. The capital categories are: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized."

We believe OTS' supervisory weaknesses were rooted in a set of tenuous assumptions regarding Superior. Despite its own increasing supervisory concerns, OTS: (1) persistently assumed that the Pritzker and Dworman interests would not allow Superior to fail and would always provide any needed capital, (2) assumed that thrift management was experienced in and had implemented sufficient controls to safely manage the complexities and high-risks of asset securitizations, and (3) unduly relied on the external auditors to attest to Superior's residual asset valuations. All three critical assumptions ultimately proved wrong.

Table 1
Overview of OTS Supervisory History

Examination Started	CAMELS Ratings[5]	Enforcement Action (Type: I - Informal, F - Formal)
July 1992	2/22232	None
July 1993	2/22221	None
Aug. 1994	2/22222	None
Sept. 1995	2/22212	None
Oct. 1996	2/22211	None
Oct. 1997	1/211121	None
Jan. 1999	2/222121	None
Sept. 1999	Follow up field visit	None
Jan. 2000	4/434221	1. 7/00 Part 570 Safety & Soundness Notice (I) 2. 7/00 Supervisory letter (I)
Oct. 2000	Follow up Field visit	1. 2/01 PCA Directive (F) 2. 2/01 Cease & Desist to Holding Companies (F).
Mar. 2001	5/554544	1. 5/01 Individual Minimum Capital Requirement Directive (IMCR) (F) 2. 5/01 PCA Directive (F) 3. 7/01 Formal Examination and Investigation

Source: OTS examination files

[5] The first number is the composite number. A rating of 1 through 5 is given, with 1 having the least regulatory concern and 5 having the greatest concern. Individual components of the CAMEL rating system are Capital adequacy, Asset quality, Management administration, Earnings and Liquidity. Effective January 1997 an additional component addressing Sensitivity to market risk was added to the examination ratings.

Recommendations

This report contains nine recommendations aimed at enhancing the supervisory and examination process. Five are directed at improving examiner coverage of accounting and valuation issues. Another covers the need for examiners to follow-up on previously reported problems. The remaining three address PCA, including the need for Federal Financial Institutions Examination Council (FFIEC) interagency deliberations over current deposit restrictions.

OTS Response and Office of Inspector (OIG) Comments

OTS generally concurred with the OIG's findings and recommendations as noted in a January 31, 2002 written response to our draft report. OTS intends to implement the recommendations within six months, and has already begun working on a number of initiatives. For the full text of OTS' response to the draft report, see Appendix 6.

Background

Superior was originally established in 1988 when the Pritzker and Dworman interests acquired Lyons Savings Bank of Countryside, Illinois. At that time, Lyons was a failing thrift with assets of $1.5 billion. Renamed Superior in 1989, the acquisition entailed an investment of $42.5 million and assistance by the former FSLIC. The corporate structure consisted of Superior being wholly owned by CCFC with the Pritzkers and Dwormans each owning 50 percent of the holding company. In 1999, Superior Holdings, Inc. (SHI), a second-tier holding company, was created between CCFC and Superior. Superior operated 17 retail branches in the Chicago metropolitan area and maintained the accounting functions and corporate offices in Oakbrook Terrace, Illinois. See Appendix 3 for the corporate organization structure.

Beginning in 1993, Superior embarked on a business strategy marked by rapid and aggressive growth into subprime home mortgages and automobile loans. This strategy was facilitated through the acquisition of Alliance Funding Company (AFC), a mortgage-banking company located in Orangeburg, New York.

AFC provided its nationwide network of brokers to support the subprime mortgage-banking program, including loan originations.

The credit risks associated with subprime lending were ostensibly lessened by removing the loans from Superior's balance sheet through a process known as asset securitization. Simply stated, the process entailed Superior transferring the loans to a third party, who then sold "asset-backed securities" to investors. The repayment of these securities was supported by the expected cash flows from the underlying subprime loans. For Superior, the securitization of subprime loans generated large non-cash earnings and inflated capital levels due to applicable accounting conventions at the time. Superior securitized subprime loans on a quarterly basis, and, in about 10 years, securitizations totaled $9.4 billion. Superior's reported earnings far exceeded its peers, with a 7.5 percent return on assets, or 7.5 times higher than its peers in 1998.

Accumulation of Complex and High-Risk Assets

Superior's profitable growth through subprime loans and securitizations did not come without risks. The securitization process created what is referred to as a residual asset arising from the sold securities and a portion of the cash flows that was to flow back to Superior after obligations of the "asset-backed securities" had been met. The residual assets are comprised of two component parts, which illustrate the associated financial and accounting complexities. One part is comprised of a financial receivable (FR) known as the interest only strip portion, the other part is a credit enhancement for the issued securities known as the overcollateralization (OC) portion. Each component is accounted for separately.

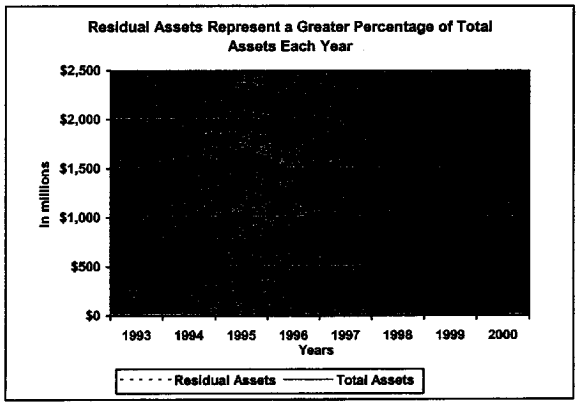
The methods and assumptions used to properly value the residual assets were critical judgments by thrift management. For example, management needed to consider factors such as the default rate of the underlying loans (credit risk), the rate borrowers might prepay loans (prepayment risk), and the interest rate used to discount the expected cash flows to obtain an accurate present value. These factors, in turn, were affected by other factors such as economic conditions and interest rate changes. Both the residual asset

values and imputed gains from the securitizations might not fully materialize if the underlying estimated factors were overly optimistic, erroneous, or actual cash flows materially differed from estimates.

Besides the risks associated with accurately valuing residual assets, Superior incurred additional risks from securitizing subprime loans. Superior provided investors and the security underwriters explicit recourse on the underlying loans. In fact, Superior retained 100 percent of the first loss position to cover credit losses up to a predetermined amount.

Along with profitability came significant growth. As Chart 1 shows, Superior's assets more than doubled from 1993 to 2000, and its dependency on residual assets similarly grew at an increasing rate.

Chart 1



Source: Superior's audited financial statements

Years of imputed gains and inflated capital from the subprime loan securitizations masked Superior's true operating results and embedded losses from flawed valuation assumptions, inaccurate prepayment rates, and unsupported discount rates. These

practices eventually led to the significant accounting write-downs that contributed to Superior's insolvency and closure. In August 2001, FDIC estimated Superior's failure would cost the SAIF between $426 and $526 million. However, on December 10, 2001, Federal regulators entered into a settlement with the Pritzker and Dworman interests, which provided for them to pay FDIC $460 million. The first $100 million was immediately paid and the remaining $360 million is to be paid over 15 years. As of December 31, 2001, the FDIC had adjusted the estimated cost of Superior's failure to $350 million by taking into account the settlement.

Findings and Recommendations

Finding 1 Causes of Superior's Failure

As previously noted, Superior's insolvency in July 2001 occurred after the owners failed to implement a capital plan that would have provided a capital cash infusion of $270 million. This set in motion a series of accounting adjustments that examiners had identified earlier in the year. The massive asset write-downs appeared to have been due to Superior's improper accounting and valuation practices. OTS' supervisory records, however, revealed that the underlying causes of failure could be attributed to thrift practices starting possibly as early as 1993. These earlier red flags and indicators of accumulating risks and associated problems were reminiscent of problem banks in the 1980s and early 1990s.

Accounting Adjustments and Asset Write-Downs Depleted Capital

As noted previously, when the principal owners failed to implement the capital plan in July 2001, OTS deemed Superior's equity to be insolvent by $125.6 million. The adjustments were necessitated after OTS and FDIC examiners determined earlier in the year that Superior had overstated the value of residual assets by $150 million due to overly optimistic assumptions used in the valuation models. Superior understated expected credit losses and used a lower discount rate than warranted, given the assets' risk profile.

Another material adjustment arose from a $36.7 million receivable due from the holding company, CCFC. In the second half of 2000,

Superior sold loans to the holding company. CCFC, in turn, sold the loans at a higher price than that paid to Superior. OTS deemed the sale transaction as a violation of 12 Code of Federal Regulations (CFR), Section 563, which requires that transactions with affiliates be on terms and conditions similarly offered to a non-affiliated company. OTS required CCFC to repay Superior, but payment was delayed reportedly due to a cash shortage at CCFC. Ultimately, recouping the $36.7 million had become dependent on the owners implementing the capital plan, which did not materialize. This and the aforementioned write-down of residual assets depleted Superior's capital from "significantly undercapitalized" to the "critically undercapitalized" PCA category.

The need for large accounting write-downs actually arose earlier than 2001. Beginning in August 2000, examiners questioned whether Superior had properly followed FAS No. 125 in accounting for the OC portion of the residual assets. Examiners determined that Superior had not discounted the OC accounts as required, and accelerated the recognition of cash flows by recording it at par value. By March 2001, Superior realized that the improper accounting would require a $270 million adjustment, thus depleting capital from "adequately capitalized" to the "significantly undercapitalized" PCA category. The impact of the accounting and valuation adjustments on capital was extensive and occurred in a short period of time. Superior's capital fell three PCA categories from "adequately capitalized" in March 2000 to substantively "critically undercapitalized" by March 2001.

Rapid Growth Resulting in an Extreme Concentration

Such a large capital depletion from a single asset type clearly reflected an unsafe and unsound practice, a condition due to an asset concentration. As Table 2 shows, Superior's concentration in residual assets existed as early as 1993 totaling $18 million for 33 percent of tangible capital, and grew to over $996 million for 352 percent of tangible capital as of June 30, 2000.

Table 2
Rapid Growth and Concentration in Residual Assets
Fiscal Years Ended June 30
(Dollars in millions)

Year	Residual Assets	Residual Assets to Tangible Capital Fund
1992	$0	0%
1993	$18.4	33%
1994	$37.1	72%
1995	$80.0	122%
1996	$155.2	149%
1997	$292.3	203%
1998	$470.4	233%
1999	$718.7	268%
2000	$996.9	352%

Source: Superior's Audited Financial Statements

Generally, an asset concentration of 25 percent of tangible capital would warrant examiner attention. The adverse impact of the accounting adjustments on capital was magnified, given the sheer size of Superior's concentration. Superior's overall risk was even greater in that the residual assets derived from the sale of subprime loans were a relatively new product and thus lacked the support of a broad liquid market, should the need arise to quickly sell the residual assets. The concentration risk also magnified Superior's exposure to credit risk given the less than normal credit quality of the underlying subprime loans. Despite the heightened risks due to the concentrations, Superior generally maintained capital levels equivalent to thrifts with less risky traditional lending activities.

Deficient Risk Management Systems

Despite the large and growing risk exposure, Superior apparently lacked certain controls and systems commensurate with its high-risk business activities. For example, Superior lacked established goals for diversification or pre-set exposure limits established by management and approved by the board. Rather than establish risk limits, management appeared to encourage growth based on compensation incentives tied to loan volume.

According to examiners, Superior also lacked financial management information systems to support its complex business strategy. For example, monthly operating results could not be readily generated

which would have facilitated the identification and monitoring of unprofitable activities. Furthermore, the financial management systems were not fully integrated, and actually relied on manual inputs to generate financial information. Daily account balances could be obtained for each general ledger account, but substantial interdivisional transactions were not eliminated until the consolidation process was completed through a myriad of spreadsheets at month-end.

Controls and systems over the valuation of residual assets were also weak. Superior relied on a third party for the securitizations and residual asset valuation models rather than performing these functions internally. Specifically, Fintek, Inc., a unit of CCFC, located in Orangeburg, New York performed these critical thrift functions. Supervisory records show that Superior paid inadequate attention to Fintek and lacked sufficient controls to ensure that key valuation functions were reliable. For example, Superior could not provide examiners with a "well-documented independent review of Fintek's model integrity." Even fundamental "stress" testing incorporating varying discount rates, default rates, and prepayment rates were either lacking or deficient.

Superior also filed inaccurate regulatory Thrift Financial Reports (TFR) that differed materially from its audited financial statements. For example, at one time residual assets were reported on a gross basis with an associated credit reserve included in the Allowance for Loan and Lease Losses (ALLL). This not only overstated the residual assets and the ALLL, but also regulatory capital. In part, many of these management system deficiencies served to mask and/or contributed to the eventual large asset write-downs leading to Superior's insolvency.

Liberal Underwriting

Credit risk was one of the key factors that ultimately affected the residual asset valuations given the dependency on the expected cash flows from the underlying loans. Credit risk also arose from the recourse provisions that Superior provided to investors to enhance the sale of "asset-backed securities." In many instances, Superior had been in a first loss position, having committed to

absorb 100 percent of any underlying loan losses supporting the issued securities.

Although exposed to credit risk from several fronts, the supervisory records indicate Superior had liberal underwriting practices, inadequate review procedures to detect inflated appraisals, and indications that employee bonuses may have been tied to loan volume. Examination records show that Superior increased the risk with its securitization activities by reducing lending quality standards beginning in 1998 and continuing through 2000. This was accomplished by originating more "C" and "D" credit quality loans than in prior years.[6] In 1997, these lower quality loans accounted for 15 percent of all originations, and by 2000, had doubled to 31 percent.

The resulting securitized loans, large in size and lower in credit quality, resulted in high delinquencies with actual loss experience exceeding Superior's expectations, especially those originated through wholesale channels.

The liberal underwriting was especially evident with Superior's subprime automobile loan business, which began in 1994. Superior's strategy was to build this lending activity in a similar fashion as the subprime mortgage-banking area by originating, securitizing, and selling the loans. Automobile loan originations went from $38.7 million in 1995 to nearly $350 million (mostly for used cars) in 1999, a nine-fold increase. Delinquencies and loan losses mounted and the subprime automobile program was discontinued in 2000, but not until Superior had lost an estimated $100 million.

Unreliable Loan Loss Provisioning

Examination files characterized Superior's understanding of the ALLL provisioning process as seriously deficient. Superior's provisioning appeared confusing and inconsistent across the different business units. At times examiners would note material excess provisioning, at other times material excess shortfalls.

[6] The cited credit rating scale was internal to Superior and went from "A" to "D", with "A" being the highest. For example, "A" loans might include borrowers with a discharged bankruptcy over 5 years ago, whereas "C" loans might include borrowers with a discharged bankruptcy within days.

In its 1994 and 1995 examination reports, OTS advised Superior of the improper inclusion of $1.6 and $2.6 million, respectively, of residual reserves in the ALLL. The excess provisioning effectively overstated the risk-based capital levels because regulations allow thrifts to include a portion of the ALLL. It was unclear from subsequent examination reports whether Superior's excess provisioning ever resulted in overstating risk-based capital beyond the "adequately capitalized" category, i.e., masking an "undercapitalized" position.

However, there were indications that the overstated capital levels may have benefited Superior in two areas. According to OTS records, the overstated risk-based capital levels enabled Superior to pay dividends of about $11.3 million in excess of Superior's own dividend policy and capital level goals. The overstated risk-based capital also may have allowed Superior to avert PCA brokered deposit restrictions as early as 1995, a time when Superior undertook significant growth.[7] These PCA restrictions are intended to curb or reverse growth by limiting an institution's funding sources. OTS analysis revealed the excess ALLL may have overstated risk-based capital for at least three quarters between August 1994 and January 1999. It was not until 2000 that the bulk of the excess ALLL provisioning was finally eliminated in the amount of $126 million.

OTS also found in 2000 that Superior's ALLL for automobile loans had a material shortfall. OTS reported that the thrift's ALLL policy did not cover all the associated risks, lacked specificity, and would not result in adequate allowances. At the time, Superior's available ALLL balance totaled $2.6 million to cover the auto loan portfolio of $578.9 million. Examiners determined that Superior needed at least $14.1 million, in effect, a five-fold provisioning shortfall in the ALLL.

Economic Factors Affecting Superior

One reason subprime lending is considered a high-risk activity is that an economic slow down will tend to adversely affect subprime

[7] Brokered deposits are funds obtained, either indirectly or directly, by or through a broker, for deposit.

borrowers earlier and more severely than standard-risk borrowers. Given Superior's focus on subprime lending and concentration in residual assets supported by subprime loans, economic and market factors would have presented added risks and greater management challenges to ensuring a safe and sound operation.

As noted previously, Superior's profitability was dependent on the cash flows of the subprime loans supporting the residual assets. One factor affecting cash flows is loan prepayments. For subprime loans, prepayments occur more frequently than for prime loans both when interest rates decline and credit worthiness improves. Credit improvement is typically the most important determinant of subprime prepayment rates as borrowers can refinance at a lower rate, and qualify for conforming standard loans after the typical 12-month credit-curing period. Increased competition in the subprime markets also increases prepayments as margins narrow and as borrowers prepay loans to refinance at more favorable terms.

Examinations in 2000 revealed that Superior had experienced greater than expected prepayments and default rates, which adversely affected residual asset valuations. As with other subprime lenders, Superior was subject to economic and market fluctuations beyond its control. However, given Superior's weak systems, polices, and controls, these external factors may have contributed to Superior's failure to a larger degree than for other institutions.

Non-Responsive Management

Many of the aforementioned red flags and indicators of developing problems were raised by OTS as early as 1993. However, the supervisory record reflects a pattern whereby thrift management promises to address supervisory concerns were not fully responsive or were not implemented. Of note were supervisory concerns regarding the growing residual assets in 1993 when AFC became a division of Superior.

Prior to acquiring AFC, Superior's management provided OTS oral assurances that it would move the risk out of the thrift by up-streaming the residual assets to CCFC. However, Superior only

up-streamed $31.1 million of residual assets out of at least $996 million through 2000. Thrift management also assured OTS that thrift resources would not be used to fund AFC's mortgage-banking activities. However, the mortgage activities continued to be funded using Superior's deposits instead of higher cost funding sources.

Besides the growing concentration in residual assets, OTS warned Superior that it needed to establish prescribed exposure limits based on risk considerations, such as anticipated loan sales and capital support. Again, thrift management and the board did not establish such limits or guiding policies covering concentration risks. As noted previously, OTS had also expressed concerns in 1994 and 1995 about the improper inclusion of residual assets reserves in the ALLL. Despite this, Superior continued this practice until 2000.

The pattern of non-responsiveness by Superior's management continued into the later years. In 2000, examiners determined that Superior had swapped $12 million in defaulted automobile loans with an external third party vendor in return for advertising credits. OTS determined the credits were worthless and subsequently received written assurances from management that the transaction would be reversed and the associated loans written-off. OTS' subsequent 2000 field visit determined that neither of the promised corrective actions had been taken. Similar incidents of non-responsive management surfaced in 2001 concerning improper loan classifications, questionable transactions with the holding company, and the need to correct previously filed TFRs.

Finding 2 OTS' Supervision of Superior

In the early years, much of OTS' supervision of Superior appeared incongruous with the thrift's increasing risk profile since 1993. It was not until 2000 that OTS expanded examination coverage of residual assets and took meaningful enforcement actions. By then it was arguably too late given Superior's high concentration in residual assets. At times, certain aspects of OTS' examinations lacked sufficient supervisory skepticism, neglecting the increasing risks posed by the mounting concentration in residual assets. PCA was not designed to prevent all financial institution failures.

However, we believe that OTS' delayed examination coverage of residual asset valuations, coupled with Superior's large concentrations, effectively negated the applicability of PCA's early supervisory intervention provisions.

Examination History and Enforcement Actions

Table 3 below summarizes the results of OTS' annual safety and soundness examinations, and enforcement actions. Also, see Appendix 4 for a detailed chronology of significant events regarding Superior.

Table 3
OTS Examination Issues and Enforcement Actions

Date Started	CAMELS Ratings	Residual Assets		Other Significant Safety and Soundness Issues	Enforcement Actions
		In millions	% to Tangible Capital		
7/20/92	2/22232	$0	0%	• Inadequate due diligence reviews of purchased loans to ensure underwriting standards were met • Understated classified assets • Inadequate loan loss reserves	NONE
7/06/93	2/22221	$18	33%	• Understated classified assets • Inadequate loan loss reserves • Concerns with residual assets' risk • Improper TFR reporting of residual assets • No comprehensive dividend policy	NONE
8/8/94	2/22222	$33	64%	• Improper TFR reporting of residual assets • Allowances for residuals credit losses included in risk- based capital • Dividends exceeded Superior's policy • Recent mortgage-banking losses • No investment limit for residual assets • Fintek and AFC intensively involved in management	NONE
9/11/95	2/22212	$66	100%	• Allowances for residuals credit losses included in risk-based capital • Concerns with underwriting appraisal values • Delays in responses to OTS because decisions are divided between home office, Fintek and AFC • Residual asset concentration presents risk to capital	NONE
10/7/96	2/22211	$148	142%	• TFR inaccurate for classified assets, capital, and brokered deposits	NONE
10/27/97	1/211121	$334	218%	• Understated classified assets • Residual asset concentration presents risk to capital • Sale of residual assets to holding company considered • Inaccurate prepayment assumptions used to value residual assets • Violations of minimum overall liquid asset requirement	NONE
1/25/99	2/222121	$521	242%	• Understated classified assets • Inaccurate prepayment assumptions used for residual assets • Unacceptable auto loan delinquencies	NONE
9/21/99	Field Visit	n/a	n/a	• Understated classified assets	NONE
1/24/00	4/434221	$869	308%	• No investment limit for residual assets • Improper prepayment and loss rates overstated residual assets • No fair market valuation performed for residual assets • Understated classified assets • Overstated loan loss reserves on TFR • Improper TFR reporting of residual assets • Delays in providing documentation to OTS	7/5/00 Part 570 Notice 7/7/00 Supervisory Letter
10/16/00	Field Visit	$977	345%	• Improper accounting and discount rate overstated residual assets • Capital and classified assets not adjusted as agreed upon • Delays in providing documentation to OTS • Inadequate loan loss reserves	2/14/01 PCA Directive 2/14/01 C&D
3/19/01	5/554544	$842	2043%	• Inaccurate discount and loss rate overstated residuals • Residual assets' concentration presents risk to capital • Out of balance accounts and the collectibility of advances unknown • Inefficient and unprofitable lending platform • Complex accounting system and reliance on quarterly reports • Understated classified assets • Inadequate loan loss reserves • Transactions with affiliate violations • Improper "right of setoff" used on TFRs which reduced assets and liabilities, and thus lowering required capital	5/24/01 PCA Directive 5/24/01 IMCR 7/24/01 Formal Examination/ Investigation

Source: OTS Reports of Examination

The examination ratings and enforcement response did not reflect supervisory concern over Superior's increasing risk exposure until 2000. From interviews with examiners, it appears any concerns they had over the mounting risks prior to 2000 was largely alleviated by Superior's high earnings and the resulting capital. Additionally, examination staff believed that thrift management had the expertise to adequately manage and monitor the activity. However, in hindsight some examiners admitted that closer scrutiny was warranted had they taken into account the quality of earnings and capital, i.e., core earnings from operations as opposed to the imputed gains afforded by gain-on-sale accounting.

Delayed Supervisory Response to Asset Growth and Concentrations

As previously noted, the high concentration levels of residual assets magnified the adverse effects of the accounting and valuation adjustments leading to Superior's insolvency. As early as 1993, OTS examinations reflected some concerns about the risks associated with residual assets, at the time totaling $18 million, or about 33 percent of tangible capital. Yet, as shown in Table 3, OTS did little to either curb the rapid growth or concentrations, which reached $977 million for over 345 percent of capital as reflected in the 2000 examination.

It was not until December 1999 that Federal banking regulators had uniform guidance over asset securitizations and related residual assets (referred to as "retained interests" in the guidance).[8] Additionally, the associated accounting complexities for this activity are reflected by the absence of any standard accounting guidance until the issuance of FAS No. 125 in 1996, and a series of subsequent clarifying guidance in 1998, 1999, and ultimately the replacement guidance, FAS No. 140, in 2000. As for the underlying subprime loans supporting Superior's residual assets, Federal regulators had not issued uniform guidance on subprime lending until March 1, 1999.

[8] *Interagency Guidance on Asset Securitization Activities,* Federal Financial Institutions Examination Council (FFIEC), December 13, 1999.

Notwithstanding the absence of regulatory and accounting guidance over asset securitizations, we believe other existing supervisory guidance for concentrations may have provided the basis for OTS to have responded earlier to limit Superior's growth and risk accumulation. OTS' regulatory handbook alerts examiners to concentration risk when it exceeds 25 percent of core capital, a level Superior exceeded in 1993 at 33 percent. And as shown in Table 3, this concentration continued to grow, at times doubling from one year to the next, to a high of 345 percent of capital as reflected in the 2000 examination.

Besides the rapid growth, there were other indicators that should have alerted examiners that Superior's activity was high-risk:

- The level of Superior's residual assets clearly surpassed all other OTS supervised thrifts. For example, by May 2000 Superior's interest strip component of the residual assets stood at $643 million, more than the combined total for the next highest 29 OTS supervised thrifts across the country. In terms of capital support, Superior's interest strip amounted to 223 percent of capital as compared to 71 percent for the next highest institution.

- The underlying subprime loans supporting the residual assets were high-risk. OTS' own internal documents to field offices in 1997 advised supervisory officials that subprime loans were considered high-risk and warranted additional examiner guidance.

- A pattern of improper TFR reporting of residual assets by Superior beginning as early as 1993.

Unfulfilled commitments by Superior's management and board to OTS to address the residual asset risks were perhaps the most telling supervisory risk indicator. OTS originally expressed concern with the residuals in 1992 when Superior acquired AFC to expand its mortgage-banking business. In response, thrift management gave OTS oral assurance that either selling or up-streaming the residual assets to the holding company would control the risk. But in the following years, residual assets continued to grow with only minor transfers to the holding company.

OTS continually recommended but did not require Superior to reduce its residual asset levels. Instead, OTS generally accepted Superior's assurances that residual assets would be sold or up-streamed to the holding company and, if not, the residual assets would be properly managed. Besides relying on management commitments, examiners and senior OTS officials believed that the principal owners would provide financial assistance should the risks adversely affect Superior.

Ineffective Enforcement Action

It was not until 2000 that OTS actively pursued enforcement action to limit Superior's residual asset growth. In July 2000, OTS directed Superior to submit an acceptable Part 570 Safety and Soundness Compliance Plan (also known as a Part 570 notice).[9] This Part 570 notice required, in part, that Superior reduce its residual assets to no greater than 100 percent of core capital within a year. By this time, however, it was arguably too late since Superior's residual assets were over 300 percent of capital; Superior had already exceeded 100 percent 5 years earlier, in 1995.

Upon closer review, we question whether the Part 570 notice was a sufficient sanction given management's prior unfilled commitments to address the residual asset risks. The Part 570 enforcement process entails an institution submitting to OTS an acceptable Safety and Soundness Compliance Plan to meet prescribed safety and soundness banking standards. Technically, the Part 570 notice is not in effect until a plan has been submitted and found acceptable by OTS. Thus additional delays might arise should a plan warrant subsequent amendments and revisions.

This was, in fact, the situation with Superior. Superior submitted an amended compliance plan in September 2000 and again in November 2000. In effect, this delayed the Part 570 process an additional 4 months. The Part 570 notice never took effect because OTS did not officially accept the plan, and eventually the action was taken over by subsequent supervisory events. Certain

[9] 12 USC § 1831 and 12 CFR § 570.

provisions of the Part 570 notice were eventually incorporated into another enforcement action in February 2001.

We asked why the Part 570 notice had been used rather than an equivalent enforcement action available under 12 USC § 1818, such as a Temporary Cease and Desist order. By using this enforcement action, many of the same provisions and corrective actions would have taken effect sooner. Two OTS senior supervisory officials told us that the Part 570 notice is not subject to public disclosure until it becomes an order, whereas other actions are subject to public disclosure when final. It was felt that public disclosure might impair Superior's ability to obtain needed financing to continue generating loans for sale. It should be noted that the FDIC, in a July 2000 memorandum, raised no objections to OTS initiating the Part 570 notice and that this was a good first step in addressing Superior's risk.

OTS was apparently still attempting to work cooperatively with Superior to resolve safety and soundness concerns. However, we believe that Superior's risk profile and management's prior record of not addressing OTS concerns warranted a more forceful enforcement action.

Aside from the timing and forcefulness of the enforcement action, we also observed that the Part 570 notice attempted to reduce the concentration risk partly by reducing residual assets to no greater than 100 percent of core capital. However, there were no provisions to further mitigate risks by requiring additional core capital coverage. This latter enforcement aspect was not addressed until 2001 with the issuance of additional enforcement actions, discussed later in the report.

We recognize that it is somewhat speculative to conclude that earlier and more forceful enforcement action would have lessened Superior's losses or prevented its failure. Nevertheless, Superior's mounting concentrations, the presence of several other high-risk indicators, and thrift management's unfilled prior commitments strongly suggests earlier enforcement action was warranted.

Examination Weaknesses Over Valuation and Accounting Problems

Superior's residual asset exposure was clearly growing beginning in 1993. From a safety and soundness standpoint, the risks were evident given the amount of residual assets relative to total assets and core capital. Yet, OTS examinations of the residual asset valuations lacked sufficient coverage during the rapid growth years up through 1999. Examiners did not exhibit the supervisory skepticism normally shown over traditional loans. Instead examiners appeared to have unduly relied on others to attest to the carrying value of Superior's residual assets, despite noted TFR reporting errors since 1993.

One specific examination weakness was the lack of on-site coverage of the third party service provider that provided the basis for Superior's residual asset valuations. Superior used Fintek Inc. of Orangeburg, New York, which was an affiliate unit through the holding company, CCFC. Fintek provided Superior with consulting services including treasury services, valuations, and modeling for the residual assets, and represented Superior in the capital markets. Fintek provided Superior the basis for the valuation models, underlying assumptions, and calculations.

OTS examiners did not conduct meaningful on-site examination at Fintek until 2001. Most of the prior examination coverage of the valuation process was not conducted at Fintek's offices in Orangeburg, New York, but instead at Superior's offices in Oakbrook Terrace, Illinois. The examination coverage at Oakbrook Terrace was comprised largely of a document review provided by Fintek and Superior's external auditor. It was not until March 2001 that OTS expanded its examination coverage and performed testing at Fintek. It was that on-site examination that ultimately led to the $150 million write-down of Superior's residual assets in July 2001.

We believe the lack of meaningful on-site examination coverage at Fintek is attributable to several factors.

- OTS lacked detailed examination procedures covering third party service providers such as Fintek. While an internal 1991 OTS examination bulletin describes some of the risk when a thrift uses a third party service provider, such as a

consultant, it does not outline the supervisory obligations of an examiner in this area.

- Securitized assets were relatively new and complex, and examiners may not have had sufficient related expertise needed to readily recognize the risks and implications of inaccurate valuations, and thus determine when closer scrutiny was warranted. Indeed, even OTS' expanded on-site coverage at Fintek in 2001 was seemingly undertaken at FDIC's urging.

- Contrary to internal guidance, OTS examiners unduly relied on Superior's external auditors to attest to the residual asset valuations recorded on Superior's financial statements. Examiner reliance placed on the external auditors was not unique to OTS. We also found undue reliance placed on external auditors by the Office of the Comptroller of the Currency during our material loss review of the First National Bank of Keystone.[10]

A senior OTS official stated that prior to 2000 there was no compelling reason to be concerned with the residual asset valuations. And examiners we interviewed expressed confidence in Superior's management who appeared knowledgeable of the asset securitization business. Notwithstanding examiner judgment at the time, we believe there were indications that closer on-site examination coverage over the valuation process was warranted earlier.

By outsourcing the valuation function to Fintek, Superior decreased its direct managerial control over a critical function, and thus intensified the need for oversight. One commonly recognized control is audit coverage of a third party service provider by the thrift's internal audit group. OTS records, however, show that Superior did not provide sufficient internal audit coverage of the valuation area. In fact, it appears that the internal auditor's independence had been compromised or unduly influenced by

[10] *Material Loss Review of The First National Bank of Keystone*, OIG-00-067, March 10, 2000. The FDIC OIG also reported a related condition dealing with external auditors in the *Material Loss Review – The Failure of Pacific Thrift and Loan Company Woodland Hills, California,* Report No. 00-022, June 7, 2000.

senior thrift managers and board members. Audit committee meetings were infrequent and Fintek operations were "off-limits" to the internal auditors despite the many critical services that were provided to Superior. In the absence of internal audit coverage, examiners were effectively placing even greater reliance on the external auditors.

As for Superior's managerial competencies, OTS apparently had not been aware that two of Superior's senior financial officials had previously held senior financial management positions at two other financial institutions. These banks had either failed or had material financial problems. One official had purportedly been terminated for cause by the failed institution prior to joining Superior. We were unable to determine, however, whether the two officials' affiliations with the two problem banks would have raised earlier questions or concerns over their managerial competencies. Nevertheless, the supervisory files do not indicate that OTS ever considered the two senior officials prior banking experience, but instead persistently believed in, and relied on Superior's management.

Undue Reliance Placed on External Auditors

Besides valuation issues, OTS examiners unduly relied on the external auditors to ensure that Superior was following proper accounting standards for the residual assets. According to OTS' 1995 Regulatory Handbook on Independent Audits, examiners "may rely" on an external auditor's findings in "low-risk" areas. In high-risk areas, examiners should conduct a more in-depth review of the external auditors' work, including a review of the underlying workpapers. OTS recognized that Superior's asset securitization and the underlying subprime loans were both high-risk areas. But, an in-depth examiner review of the auditor's workpapers did not occur until late 2000, many years after Superior had built up a large risk exposure.

We believe the events leading up to the examiners eventually discovering the accounting error resulting in the $270 million write-down suggest that examiners may not have had sufficient expertise and familiarity with the complexities surrounding the accounting and/or valuation issues for residual assets.

Shortly after the joint OTS and FDIC examination in January 2000, an FDIC analyst noticed that other institutions' financial data had reflected downward adjustments that had been made to conform to the 1998 FAS No.125 clarifying guidance (known as Questions and Answers). Simply stated, the FAS issuance clarified how the residual asset OC component should be recorded using a present value rather than a par value basis.[11] The absence of this downward adjustment in Superior's financial statements prompted the FDIC analyst to urge OTS to include in its October 2000 field visit a more detailed review of the audited financial statements and the external auditor's underlying workpapers.

OTS' October 2000 field visitation eventually led to the determination that Superior had incorrectly recorded residuals by as much as 50 percent. Supervisory records also show that the external auditors could not provide sufficient support for Superior's fair value modeling or accounting interpretations. These would have been reflected in Superior's audited financials for the preceding fiscal year ending June 30, 2000.

One of the provisions of the Part 570 enforcement action of July 2000 further illustrates the undue reliance placed on the external auditors. Due to valuation concerns, Superior was required to obtain an independent valuation for sampled residuals to validate the results produced by Fintek. Superior used the same accounting firm that had audited its financial statements ending June 30, 2000. We found no indication that OTS considered the implications of Superior relying on the same firm to validate a major area that it covered in its audit. In effect, Superior was asking the firm to validate its financial statement audit work.

We acknowledge that current auditing standards do not preclude using the same firm for valuation services and financial statement audits. We also recognize that two different offices of the same accounting firm conducted the valuation versus financial statement audit. But the supervisory record does not indicate that examiners questioned this particular arrangement or attempted to assess

[11] The 1998 Questions and Answers specifically clarified the conditions for recognizing residual cash flows under a "cash-in" versus "cash-out" basis.

whether the external auditor's validations might warrant further examiner review. Additionally, OTS records show that the required independent validation had not been fully completed as specifically required by the Part 570 enforcement action, and there was no indication that OTS ever raised this issue with Superior as being non-responsive to the Part 570 notice.

Given the risk indicators previously mentioned, we believe much of OTS' earlier year examinations that lacked normal supervisory skepticism to test, validate, and verify Superior's valuations and procedures can be attributed to a combination of reasons. The supervisory files and interviews with supervisory officials lead us to believe that examiners may not have been fully sensitive to the complexities of a new product for which there was little guidance to assess risk. The apparent supervisory indifference to Superior's mounting risks through 1999 was partly sustained by OTS' belief in thrift management's expertise, coupled with examiners' undue reliance on the external auditors to attest to Superior's valuations and accounting practices.

Provisioning Issues Not Followed-Up

As previously noted in Finding 1, the supervisory records surfaced several problems regarding Superior's provisioning processes for loan losses. In its 1994 and 1995 examinations, OTS reported that Superior improperly included a portion of the residual asset reserves in the ALLL. The potential effects include overstating Superior's risk-based capital levels, which in turn may have allowed Superior to pay excess dividends. Overstated capital may have also negated the PCA brokered deposits limitations during Superior's rapid growth years through 1999.

The supervisory record is silent on the excess provisioning issue until the 2000 examination, at which time OTS required Superior to reduce the ALLL by $126 million. We asked examiners why the 1994 and 1995 deficiencies had not been followed up in the 1996 examination. The examiners could not recall why they did not follow up, but assumed that the issue had been resolved. However, we could not determine from the supervisory files that the issue had even been considered for follow-up purposes, and there were no notations to the supervisory files that the issue had

been resolved. The 1996 and subsequent examination reports up to 2000 show an increasing ALLL, including a portion for the residual assets.

Besides the normal practice of following-up on a previously reported deficiency, there was another indicator suggesting the need for examiner follow-up. Superior's reported reserves and provisions for generally accepted accounting principles (GAAP) purposes differed from that reported for regulatory purposes (i.e., TFR). In 1998, the reported regulatory levels were about double over that reported under GAAP, even though TFR reporting instructions would not suggest there should have been a difference. Again, this type of reporting difference with an excess ALLL could have resulted in overstated risk-based capital.

A senior OTS official, in a December 21, 2001, letter to the FDIC Office of Inspector General stated that the lack of follow-up was due to the complexities of the associated accounting standards. Furthermore, according to the OTS official, the 1996 FAS clarifying guidance took the accounting community an additional 3 years to fully understand and apply consistently. The OTS official further pointed out that other non-thrifts continue to report this item in a similar manner as Superior.

Finding 3 Prompt Corrective Action

Enacted in 1991, Prompt Corrective Action (PCA) provides Federal banking regulators an added enforcement tool to promptly address "undercapitalized" banks and thrifts. PCA consists of a system of progressively severe regulatory intervention that is triggered as an institution's capital falls below prescribed levels. PCA does not replace or preclude the use of other available enforcement tools (e.g., cease and desist orders, removal actions, civil monetary penalties) that address unsafe and unsound banking practices before capital becomes impaired. PCA aims to minimize losses to the FDIC deposit insurance fund by providing for a quick regulatory response to troubled institutions.

OTS used PCA in response to Superior's problems. But some of the PCA early intervention provisions may have been negated by OTS' delayed supervisory response in detecting problems. OTS

also appeared to have exercised regulatory forbearance by delaying the recognition of Superior's true capital position in early 2001. OTS may also have failed to enforce one of the PCA restrictions over senior executives' bonuses. Superior's ability to quickly replace brokered deposits with insured retail deposits possibly raises an aspect of PCA that may warrant further regulatory review.

Prompt Regulatory Intervention Slowed by Delayed Detection

PCA's progressively severe mandatory enforcement provisions are triggered as a thrift's capital is depleted below prescribed capital categories. As such, PCA is dependent on a lagging indicator because capital depletion or the need for capital augmentation occurs only as quickly as thrift management or regulators recognize problems. As previously noted, Superior's recorded capital fell precipitously in just one year's time, from "adequately capitalized" in March 2000 to substantively "critically undercapitalized" by March 2001.

The supervisory record and the aforementioned audit findings suggest several instances where supervisory delays likely resulted in not recognizing Superior's true capital position. As a result, these likely delayed the automatic triggering of certain PCA provisions. For example, the delayed examiner follow-up on the 1994 and 1995 reported ALLL deficiencies effectively resulted in overstated capital levels as early as 1996, and again in 1997 and 1999. Had Superior's true capital level been known, perhaps the PCA restriction over the use of brokered deposits could have been invoked sooner to stem the growth and buildup of risky residual assets. As noted in Finding 1, Superior's most significant mounting risk exposure occurred from 1993 through 2000.

Other instances where delayed supervisory detection negated PCA include the $270 million accounting adjustment initially detected in October 2000 and the $150 million valuation write-down originally determined in late May 2001. Both of these events surfaced when OTS expanded its examination coverage of the external auditor's workpapers in late 2000 and at Fintek in 2001. The $270 million adjustment effectively lowered Superior's capital to the "significantly undercapitalized" level. The associated adjustments

had been based on Superior's financial statements for the fiscal year ending June 30, 2000. However, the applicable accounting standard had been issued in late 1998, and thus its application could have been verified against Superior's audited fiscal year 1999 financial statements. Had that been done, the accounting error would have been detected a year earlier, and Superior would likely have been required to submit a PCA capital plan to address an "undercapitalized" PCA level.

The $150 million valuation write-down was due to overly optimistic assumptions used in Superior's valuation models. The external auditor's inability to validate Superior's valuation models, Superior's inability to provide documentation of the underlying assumptions, and the lack of stress testing all likely existed prior to OTS' discovery of these deficiencies in late 2000. Of importance was that this adjustment lowered Superior's capital to the "critically undercapitalized" level, at which time PCA's 90-day closure rule would start.

We recognize that it is somewhat speculative that had OTS detected problems earlier, PCA's early intervention provisions would have, in turn, been triggered sooner. Nevertheless, we believe that Superior's mounting risk exposure since 1993 provided OTS the basis for expanding examination coverage sooner than 2000. And while no single problem alone would have conclusively prompted an earlier PCA trigger, given the large number of different problems that led to Superior's insolvency did little to evoke the notion that PCA as an enforcement action had been diminished. Rather, OTS' delayed detection of so many critical problem areas suggests that the advantage of PCA as an early intervention tool is as much dependent on timely supervisory detection of actual, if not developing problems, as it is on capital.

Indications of Regulatory Forbearance

The supervisory files suggest that OTS on several occasions extended to Superior regulatory forbearance. The nature of the observed forbearance relates to the additional time OTS provided Superior to obtain additional capital after it was readily apparent the thrift was near insolvency. The forbearances took the form of either delaying the recognition of known write-downs or providing

liberal regulatory interpretations of transactions that effectively allowed Superior to remain above certain PCA capital levels.

Valuations Delayed

Shortly after determining that Superior had improperly accounted for the residual assets, OTS continued looking into Fintek's valuation models. The accounting problem resulted in a write-down of $270 million, effectively lowering Superior's capital position to the "significantly undercapitalized" level. In February 2001 OTS issued Superior a PCA directive, which included requiring Superior to submit a capital plan. By May 7, 2001, examiners had clear indications that Superior's overly optimistic valuation assumptions would necessitate an additional write-down of at least $100 million. This additional write-down would have effectively lowered Superior's capital below the 2 percent "critically undercapitalized" level, at which time PCA's severest mandatory restrictions would have been triggered. Eventually, a $150 million write-down occurred in July 2001 after the principal owners failed to implement the capital plan. Based on the supervisory files, it appears that the additional write-down had not been immediately made due to OTS' acceptance of Superior's proposed capital plan on May 24, 2001.

Assets Not Recorded

Another instance of delayed supervisory action relates to Superior's application of an accounting standard (i.e., "right of set-off") that allowed it to exclude certain assets from being reported in the March 2001 TFRs. The assets consisted of loans that Superior committed to sell, and Superior's accounting treatment effectively served to keep its regulatory capital above the "critically undercapitalized" level. The substance of the sales transaction did not meet either regulatory or accounting standards for the "right of set-off" treatment. As with the earlier delayed write-down, OTS' approval of the capital plan in May 2001 became the overriding consideration precluding the needed adjustment to the March 2001 TFR.

Non-Cash Capital Contribution

In another instance, Superior included in the March 2001 TFR a non-cash capital contribution from CCFC. The contribution consisted of the beneficial interests of $81 million of residual assets, which effectively served to keep Superior's capital above the "critically undercapitalized" level. OTS' Regulatory Handbook does not generally permit the inclusion of non-cash assets for determining core capital. The OTS handbook does provide some flexibility on a case-by-case basis, but Superior's tenuous financial condition at the time seemed to have merited closer adherence to the prescribed regulatory policy. OTS raised objections to this previously and did not officially allow Superior to include the non-cash contribution. Instead, OTS requested on May 3, 2001 that Superior provide additional documentation in the form of legal and accounting opinions in support of the transaction. This request for additional documentation became part of the approved capital plan.

Aside from the additional time accorded Superior, it also seemed incongruous to allow Superior to accept the residual asset contribution at a time it needed to reduce, not increase, its residual asset exposure. The July 2000 Part 570 notice required that Superior's residual assets not exceed 100 percent of core capital, so the residual asset contribution seemed inconsistent with OTS' earlier enforcement efforts. It should be noted that the supervisory files do not show an adjustment was made to remove the non-cash contribution from Superior's financial reports.

Preferential Application of Risk-Based Capital Requirements

Superior's capital plan conditionally approved by OTS on May 24, 2001, included provisions to sell and pledge assets to finance a part of the underlying capitalization arrangement. At issue is OTS' assessment as to how much capital Superior would need to apply against the sold loans and pledged assets. The level of capital that OTS approved under the capital plan may have been less than needed by as much as $148 million according to FDIC calculations.

This short fall arises from OTS allowing Superior relief from existing risk-based capital standards. The capital required against

the pledged assets would not have been based on a single scale (i.e., risk weight of 100 percent) but rather a graduated scale extending over 9 years. The graduated scale started out at 50 percent less than the existing capital requirement, and increasing each subsequent year. The existing capital requirement would not have been reached until June 2005. The other preferential capital treatment was the absence of any capital Superior would need against the loans sold with recourse. According to a FDIC memorandum to OTS, the relief afforded Superior was not consistent with existing capital treatment by the other regulatory agencies on recourse arrangements.

Violation of a Mandatory PCA Restriction

Superior may have violated the PCA mandatory restriction against paying excessive bonuses to senior executives. The restriction was part of the PCA Directive of February 2001. Under this restriction, Superior was required to limit payments to senior executives to the base salary over the preceding 12 months. From March to July 2001, a total of $220,000 in bonuses was paid to 10 senior executives. An OTS official was not aware of the bonuses.

Brokered Deposit Restrictions

Under PCA the use of brokered deposits and the rates paid on deposits are automatically restricted when an institution's capital falls below the "well capitalized" category. At that point, a waiver must be obtained from FDIC for the continued use of brokered deposits, and retail deposit interest rates cannot exceed 75 basis points (0.75 percent) above comparable market rates. These PCA restrictions serve to curb or reverse growth, and thus risk, by limiting an institutions' funding sources. For Superior these restrictions were automatically triggered in April 2000.

OTS' thrift financial monitoring reports showed that the intended restriction did not appear particularly effective for Superior. Superior did not obtain an FDIC waiver, but instead replaced brokered deposits with insured retail deposits. At June 2000, brokered deposits totaled $367.2 million, which dropped to $80.9 million by June 2001, a month before Superior's closing. Insured

deposits at June 2000 totaled $1.1 billion and by June 2001 totaled $1.5 billion, effectively replacing the drop in brokered deposits.

It should be noted that Superior's reported funding was within the limits of the regulation, but perhaps not necessarily the intent with respect to limiting FDIC's exposure.

OTS agreed that the cited financial data reflects the replacement of brokered deposits with retail insured deposits. However, OTS believed that most of the reported brokered deposits had been insured, so the retail deposit replacements may not have exposed FDIC by the cited amounts. OTS suspected that Superior had not accurately reported its deposit composition, although OTS could not provide documented support showing the extent of the reporting error or the actual levels of insured brokered deposits. Aside from the specific amounts, OTS nevertheless agreed that the ability of institutions to readily replace uninsured deposits, whether brokered or not, with insured deposits was an area warranting regulatory review.

Recommendations

In Finding 1, we noted that improper accounting and inflated valuations of residual assets appeared to be the immediate causes of Superior's insolvency in July 2001. But a major contributing factor was Superior's high concentration in residual assets exceeding 350 percent of tangible capital that had exacerbated the magnitude of losses.

In Finding 2, we noted that OTS neglected to address Superior's growing concentration by either limiting the concentration or requiring capital coverage. We do not have a recommendation addressing this aspect of Superior's failure because in November 2001 the joint banking regulatory agencies issued new regulations covering residual interests in asset securitizations. The new regulations require a 25 percent core capital limitation and dollar-for-dollar capital allocation for exceeding the 25 percent limit. Had this regulation been in effect earlier, we believe it would have greatly mitigated Superior's risk as early as 1993.

Recommendations 1 - 5

In Finding 2, we also noted several concerns over OTS' examination coverage of Superior's critical accounting and related valuation activities. Accordingly, we recommend that the Director of the Office of Thrift Supervision:

1. To better ensure adequate examination coverage of third party service providers, as in the case of Fintek, issue further detailed examiner guidance in this area. Consideration should be given to either expanding the 1991 Thrift Bulletin or establishing additional examination procedures for the *Regulatory Handbook*, which includes detailed guidance on the supervisory obligations of examiners. Suggested areas of coverage include:

   - Assessing the adequacy of thrift management and board controls to identify, monitor, and manage the risks associated with third party relationships.

   - Determining risk factors and conditions, which warrant direct on-site examination coverage, and include the frequency and areas subject to mandatory coverage.

   - Determining expected documentation for an examiner's risk assessment of the nature and extent that third party relationships may threaten a thrift's safety and soundness.

2. To ensure that sufficient examination coverage is provided to geographically dispersed operating units (a) assess the adequacy of existing OTS monitoring controls over examinations of thrifts whose critical functions are geographically dispersed, and (b) provide for additional quality assurance reviews of these examinations. We believe that this additional emphasis is needed because we recognize other thrifts may house internally key functions at dispersed locations, such as with Fintek and AFC.

3. To better ensure examiners adhere to the *Regulatory Handbook* on Independent Audits, require that quality assurance reviews cover examinations where an expanded review of the external auditor's workpapers would have been warranted. As an interim measure, supervisory examination officials should emphasize with examiners the requirements of the handbook, and consideration should be given to having OTS regional offices conduct a risk assessment in this area for their existing supervisory portfolio.

4. To better ensure adequate examination coverage of thrifts' proper application of new accounting pronouncements and standards, reassess existing examination guidance in this area. We recognize that the examination function should not duplicate the external auditor's work. However, given the nature and extent of Superior's accounting write-down adjustments in 2001, we believe a reassessment of OTS examination coverage is warranted. OTS examinations should focus on those new accounting policy areas that would present a material risk to thrifts' financial condition and capital adequacy. As an interim measure, consideration should be given to OTS regional offices conducting a risk assessment in this area for their existing supervisory portfolio.

5. To better ensure that examiners sufficiently cover thrifts' valuation policies and practices for residual assets, establish minimum testing procedures in addition to assessing the adequacy of thrift management policies, procedures, and controls in this area.

Recommendation 6

In Finding 2, we also reported the lack of timely examiner follow-up of a previously reported concern dealing with Superior's inappropriate inclusion of residual asset reserves in the ALLL. Because we do not know whether this is a systemic deficiency, we recommend that the Director of the Office of Thrift Supervision:

6. Ensure that planned quality assurance reviews of examinations cover the adequacy of examiner follow-up on previously reported problems.

Recommendations 7 – 8

In Finding 3 we also reported that Superior may have violated a PCA restriction when it paid senior executives approximately $220,000 bonuses in 2001. Accordingly, we recommend that the Director of the Office of Thrift Supervision:

7. Assess whether appropriate enforcement sanctions should be pursued.

8. Assess the adequacy of existing supervisory controls used to ensure thrift compliance with PCA restrictions.

Recommendation 9

In Finding 3 we observed how readily Superior replaced brokered deposits with insured retail deposits, seemingly negating the deposit funding restrictions under PCA. Although this was technically not a violation of PCA, it may have likely increased the cost of Superior's failure to the insurance fund, and negated any intended PCA funding restrictions. Accordingly, we recommend that the Director of the Office of Thrift Supervision:

9. Raise before the FFIEC the need to assess whether legislative or regulatory revisions to PCA are warranted with respect brokered deposit restrictions. This evaluation should focus on the relative ease at which institutions can replace non-insured with insured deposits.

Management Response and OIG Comments

In its January 31, 2002, written response to our draft report, OTS generally concurred with our reported findings and recommendations. OTS intends to implement the recommendations within six months. In August 2001, in connection with their own internal review, OTS had already begun

working on a number of initiatives in line with our recommendations.

We believe OTS' commitment to take corrective action is substantively responsive to the recommendations in light of their ongoing initiatives beginning in August 2001. Although specific corrective actions were not noted in the OTS response, the OIG will continue to monitor OTS' progress in addressing the reported findings and recommendations. The full text of OTS' written response is included in Appendix 6.

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We would like to extend our appreciation to OTS for the cooperation and courtesies extended to our staff during the audit. Major contributors to the report are listed in Appendix 7.

Benny W. Lee

Benny W. Lee
Regional Inspector General for Audit

We conducted this material loss review of Superior Bank in response to our mandate under Section 38(k) of FDIA, 12 USC § 1831o(k). This section provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution on or after July 1, 1993, the inspector general for the appropriate Federal banking agency shall prepare a report to the agency, which shall:

- ascertain why the institution's problems resulted in a material loss to the insurance fund;
- review the agency's supervision of the institution; and
- make recommendations for preventing any such loss in the future.

As defined by Section 38(k) of FDIA, a loss occurring after June 30, 1997, is considered material if it exceeds $25 million or 2 percent of the institution's total assets. FDIA also requires the inspector general to complete the report within 6 months after it becomes apparent a material loss has been incurred.

We initiated a material loss review of Superior based on the loss estimate by the FDIC. As of August 6, 2001, FDIC estimated that Superior's failure would cost the SAIF between $426 and $526 million. On December 10, 2001, the regulators and the former principal owners entered into an agreement to pay FDIC $460 million. As of December 31, 2001, FDIC adjusted the estimated cost of Superior's failure to $350 million taking into account the settlement. This also factors in the financial impact of several resolution transactions such as asset sales, that the appointed conservator has completed and planned.

To accomplish our review, we conducted fieldwork at OTS Headquarters in Washington, D.C., and its Regional Office in Chicago, Illinois. Additionally, we visited FDIC's Division of Supervision (DOS) in Chicago, Illinois and the Division of Resolutions and Receiverships (DRR) and the Division of Finance (DOF) in Dallas, Texas.

Our review covered the period from 1989 until Superior's failure on July 27, 2001. We conducted our fieldwork from August 2001 to January 2002.

To assess the adequacy of OTS' supervision of the thrift, we attempted to determine (1) when OTS first identified Superior's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OTS took to get the thrift to correct the problems. Additionally, we attempted to determine whether OTS (1) might have discovered problems earlier, (2) identified and reported all the problems, and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we:

- Assessed OTS actions based on its internal guidance, legislative guidance provided by Financial Institutions Reform, Recovery, and Enforcement Act of 1989, FDIA, and interagency banking guidelines on subprime and securitization activities. We also considered changes in the regulators' and industry's policies and guidance throughout the years and compared these policies to current ones.

- Reviewed supervisory and enforcement files and records for Superior and its holding companies from 1989 through 2001 that were maintained at OTS Headquarters, and the Chicago Regional Office. We analyzed all examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed this analyses to gain an understanding of the problems identified, the approach and methodology OTS used to assess the thrift's condition, and the regulatory action used by OTS to compel thrift management to address the deficient conditions found. We did not conduct an independent or separate detailed review of the external auditors work or associated workpapers, other than those incidentally available through the supervisory files.

- Reviewed files, workpapers, and examination reports maintained by FDIC's Chicago DOS to determine the nature, scope, and conclusions regarding its reviews of Superior.

- Interviewed and discussed various aspects of the supervision of Superior with OTS officials, examiners, capital market specialists, attorneys, an analyst, and an accountant to obtain their perspective on the thrift's condition and the

scope of the examinations. We also interviewed FDIC officials and DOS examiners who had participated with OTS on two examinations at Superior, or who were responsible for monitoring Superior for Federal deposit insurance purposes.

- Interviewed the FDIC DRR and DOF personnel who were involved in the receivership process and in the due diligence reviews, which were conducted prior to and after Superior's closure and appointment of the conservator.

- Discussed the progress of FDIC's investigative efforts with FDIC DRR investigators in Dallas, Texas.

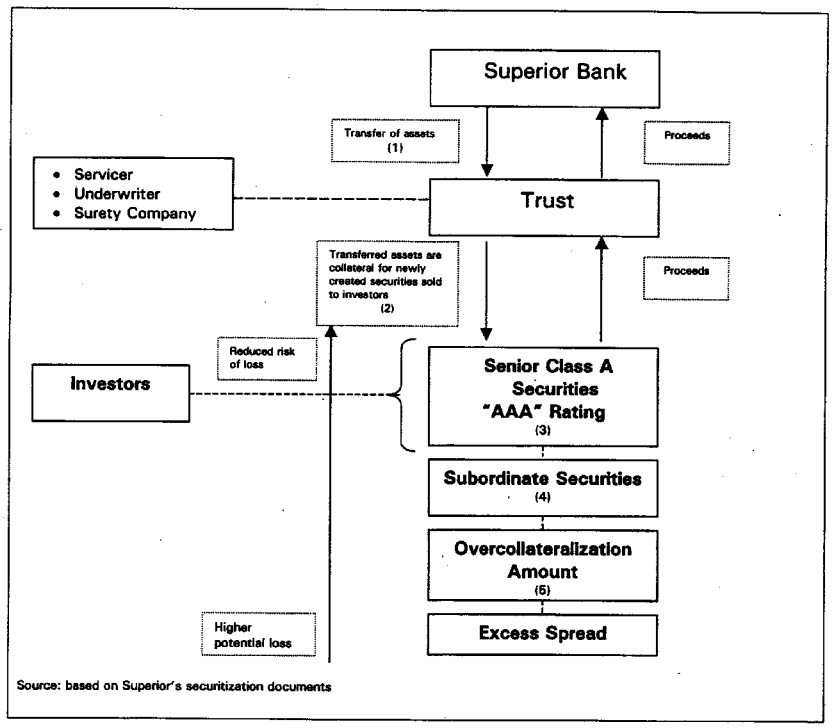
We conducted our review in accordance with generally accepted government auditing standards. However, we were unable to fully assess certain aspects of OTS' supervision of Superior. This is due, in part, to delays by OTS in providing us with documents obtained through 24 subpoenas issued after July 27, 2001. OTS issued the subpoenas as a result of Superior's failure, in part, to determine the need for any subsequent enforcement action. We specifically requested the information to determine their relevancy in assessing OTS' supervisory efforts in promptly identifying unsafe and unsound banking practices, and pursuing available enforcement action as appropriate.

We initially discussed the contents of the 24 subpoenas with OTS on November 19, 2001, and requested copies of the subpoenas from OTS Chief Counsel's office on November 29, 2001. We again requested the information in a memorandum to OTS dated December 17, 2001. In response to the memorandum, we were provided access to the requested information on December 21, 2001.

We subsequently determined that the 24 subpoenas had generated numerous documents that exceeded the volume of documents in support of the original supervisory files that we reviewed in Chicago. Due to the legislatively mandated timeframes for this report, there was insufficient time to review this information. It is our intention, however, to continue reviewing these documents, and issue a subsequent report should any material findings arise from this review.

Superior's loan securitization activity consisted of originating and purchasing subprime loans, pooling the loans together, packaging them as "asset-backed securities", and selling the securities to investors. The thrift relied on two securitization structures. The first type used a senior/subordinated multi-class structure in which Superior retained the most subordinated securities. The second type, OC, used an excess spread and a 100 percent surety wrap structure to support the issuance of the "asset-backed securities". Chart 2 shows the securitization structure, and notes on the next page explain the process:

Chart 2
Superior's Securitization Process



Source: based on Superior's securitization documents

(1) Superior generated subprime loans for resale through real estate mortgage investment conduits (REMIC) issuances and sold the principal and interest securities to third party investors using underwriters and a third party trust.

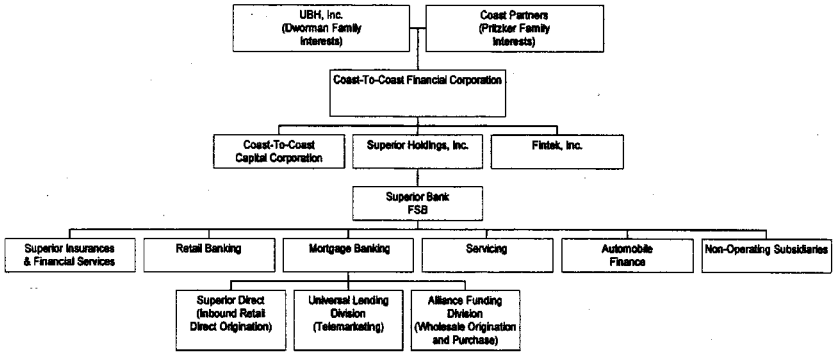
(2) Superior transferred the loans as collateral for the securities to a third party trust, who then sold the "asset-backed securities" to investors.

(3) The securitization process provided a method for Superior to convert pools of loans into a mix of "AAA" grade marketable securities and lower grade subordinate credit risk securities. The principal and interest of the securities are paid from the expected cash flows from the underlying subprime loans. The cash flow from the pool loans was applied to the interest and principal payments to the investors in the order of their seniority. In essence, the cash flows from the entire pool created a waterfall effect. Principal and interest payments to senior security holders were met first, with remaining cash, if any, cascading down to pay more subordinate securities in order of their priority.

(4) When a loan securitization was sold, Superior retained the subordinate securities that held the excess spread account. The excess spread represents the right to receive future cash flows that result from the difference (i.e. spread) between the interest paid by the loan borrowers, and the interest rate paid to the securities holders. A residual asset, referred by Superior as a financial receivable, was created by recording the imputed present value of excess spread cash flows on the REMICs sold, after deducting the applicable expenses (i.e. fees paid for credit insurance, trustee services, loan servicing, etc.). Superior was in a "first loss" position to cover credit losses in the loan pool up to a predetermined amount. Superior received cash flows only after absorbing 100 percent of the future credit losses incurred through defaults or prepayment of the underlying loans.

(5) To obtain an "AAA" rating for the security certificates, Superior also established another form of credit enhancement to the securities known as an OC account. The OC on the securitization was pledged to the REMIC security insurer and trustee, to provide cash collateral as a cushion to absorb any credit losses before the insurance company had to cover the losses. The insurance company calculated the OC cash amount level required for this cushion. These cash flows were held by the trustee and used to prepay the senior security investors up to the targeted OC level. Excess cash flow was released to Superior only after the OC targets were met and maintained. These cash flows were not received by Superior until much later in the life of the trust.

Appendix 3
CCFC and Superior's Organization Structure



Source: OTS Supervisory files

The following chronology describes significant events in Superior's history including: examinations conducted, major problems identified, and enforcement actions taken by OTS.

12/30/88	Pritzker and Dworman families acquire Lyons Savings Bank, a FSB through a federally assisted supervisory merger.
4/14/89	Lyons Savings Bank changes name to Superior Bank, FSB.
6/9/89	Federal Home Loan Bank Board of Chicago, predecessor to OTS, conducts a special limited examination and determines that Superior's financial reports accurately reflect the thrift's financial condition.
12/18/89	OTS a conducts a safety and soundness examination. CAMELS Ratings: 3/32233N. Exam completed 3/30/90.
1/19/90	FDIC conducts a regular examination. FDIC Ratings: 4/41334. Exam completed 3/30/90.
3/28/91	OTS conducts a safety and soundness examination. CAMELS Ratings: 2/12222N. Exam completed 5/6/91.
3/29/91	FDIC conducts a concurrent Tier II examination. FDIC Ratings: 3/32333. Exam completed 4/26/91.
10/91	Fintek, Inc., an affiliated management company, is formed. Fintek provides Superior with treasury services, valuations, and modeling for the residual assets and represents the thrift in capital markets.
4/4/92	FDIC conducts a Tier III Examination, limited scope examination. FDIC Ratings: 3/32232. Exam Completed 4/24/92.
7/20/92	OTS conducts a safety and soundness examination. CAMELS Ratings: 2/22232N. Exam completed 8/28/92.

12/92	With the approval of OTS, Superior acquires AFC, an affiliated wholesale lender that originates subprime mortgage loans. With this acquisition, Superior's focus shifts to nationwide subprime mortgage-banking, packaging and securitizing loans in the secondary market.
3/31/93	Superior executes its first securitization and sale of mortgage loans, reports its first gain-on-sale income, and accumulates residual assets retained from the mortgage securitizations.
7/6/93	OTS conducts a safety and soundness examination. CAMELS Ratings: 2/22221N. Exam completed 8/12/93.
1994	Superior begins its automobile lending division. Auto loans are to be securitized and sold in a manner similar to the mortgage-banking division.
8/8/94	OTS conducts a safety and soundness examination. CAMELS Ratings: 2/22222. Exam completed 9/9/94.
12/15/94	President of Fintek unanimously elected chairman of Superior's Board.
9/11/95	OTS conducts a safety and soundness examination. CAMELS Ratings: 2/22212. Exam completed 10/31/95
6/28/96	Financial Accounting Standards Board (FASB) issues FAS No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* which recognizes gain-on-sale accounting for economic interests retained in assets sold.
10/7/96	OTS conducts a safety and soundness examination. CAMELS Ratings: 2/22211N. Exam completed 11/20/96.
1/1/97	FAS No. 125 becomes effective.
10/27/97	OTS conducts safety and soundness examination. CAMELS Ratings: 1/211121. Exam completed 12/5/97.

12/98	FASB issues a second edition of Questions and Answers to FAS No. 125, which recommends use of the "cash-out" method to value gain-on-sale assets.
12/28/98	FDIC sends OTS a written request to participate in the next examination of Superior due to residual asset concerns identified during FDIC's off-site monitoring.
1/15/99	OTS verbally denies FDIC's request to participate in the January 1999 examination, but arranges for FDIC to meet with OTS examiners to review OTS workpapers.
1/25/99	OTS conducts a safety and soundness examination. CAMELS Ratings: 2/222121. Exam completed 3/1/99.
6/4/99	FDIC notifies OTS that it is downgrading Superior's overall CAMELS rating from "2" to "3." The downgrade is due to the thrift's extremely high exposure to subprime credit and residual assets. FDIC CAMELS Ratings: 3/333122
6/30/99	CCFC transfers 100 percent of its ownership in Superior to SHI in the form of a capital contribution. SHI is a wholly owned subsidiary of CCFC.
7/99	FASB issues the third edition of Questions and Answers to FAS No. 125, which further clarifies it.
9/17/99	FDIC sends a letter to OTS to confirm that FDIC will participate in the next examination. OTS concurs.
9/21/99	OTS conducts a field visit examination as follow-up to deficiencies in reporting of classified assets found in the 1/25/99 full-scope examination.
12/13/99	Federal banking regulatory agencies issue *Interagency Guidance on Asset Securitization Activities,* which emphasizes that any securitization-related retained interest will be supported by documentation of the interest's fair value.

1/24/00	OTS conducts safety and soundness examination with FDIC participating. CAMELS Ratings: 4/434221. Exam completed 3/30/00.
2/17/00	OTS and FDIC review the 6/30/99 external auditors audited workpapers.
6/30/00	Superior ceases its securitization activities but continues to originate subprime loans for sale to affiliates, with the servicing retained by Superior.
7/5/00	OTS issues a *Notice of Deficiency and Requirements for Submission of a 12 CFR, Part 570 Safety and Soundness Compliance Plan* to Superior. As part of the 570 notice, OTS directs Superior to reduce the level of residual assets to no greater than 100 percent of Tier 1 capital within a one-year time period.
7/7/00	OTS issues a Supervisory Letter that officially notifies Superior it is designated a "problem association" and an association in "troubled condition."
8/4/00	Superior submits a safety and soundness compliance plan to OTS.
8/22/00	OTS suggests to external auditors that the external auditors contact its national office to verify that the accounting treatment of the OC asset is correct.
9/00	FAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a Replacement of FAS No. 125* was issued, which revises the standards for accounting for securitizations but carries over most of FAS No. 125's provisions.
9/1/00	OTS requests additional information from Superior on its safety and soundness compliance plan.

9/29/00	Superior submits response to OTS the 9/1/00 request for additional information on the safety and soundness compliance plan.
10/16/00	OTS and FDIC conduct a field visit examination and find that residual assets are inflated by an estimated $200 to $300 million due to the absence of acceptable valuation procedures and improper accounting treatment. Exam completed 1/16/01.
10/27/00	OTS requests additional information on Superior's safety and soundness compliance plan.
10/30/00	OTS and FDIC visit the external auditors' office to assess the level of support in the June 30, 2000 audit workpapers for the accounting treatment and validation of the residual assets.
11/09/00	OTS and FDIC meet with external auditors to review the cash flow models for Superior's residual assets and how the external auditors validated the models. Regulators request that the thrift and external auditors provide support for carrying the OC asset on a non-discounted basis.
11/13/00	Superior submits a response to OTS 10/27/00 request for additional information on the safety and soundness compliance plan.
11/22/00	OTS directs Superior to write-down the OC account and amend the 6/30/00 and 9/30/00 TFRs.
12/14/00	Superior ceases its subprime auto lending operations.
12/19/00	OTS and FDIC meet with Superior and external auditors to discuss accounting treatment of the OC asset. Management and external auditors continue to disagree with the regulators' position that OC asset must be recorded using cash-out method. External auditors are given additional time to provide written support for their position. The Chief Accountant at OTS Headquarters is made aware of the situation.
12/20/00	OTS Central Region notifies Superior that it is extending the time for its review of Superior's safety and soundness compliance plan because of

the outstanding issue regarding accounting treatment of the OC asset.

1/11/01	The external auditors' national office acknowledges that the accounting treatment applied to the OC asset is improper and proposes a revaluation of the residual assets. The revaluation ultimately results in a $270 million downward adjustment in the fair market value of the OC assets.
2/12/01	OTS deems Superior to be "significantly undercapitalized" as of December 31, 2000. Superior is required to file a capital plan with OTS no later than March 14, 2001.
2/14/01	OTS issues a PCA Directive to Superior, which prohibits asset growth and requires weekly sales of all loans originated during the prior week. In conjunction, SHI and CCFC consent to a Consent Order to Cease and Desist which requires the holding companies to maintain an escrow account at Superior for coverage of any losses incurred from required weekly loan sales.
2/15/01	OTS terminates its review of Superior's safety and soundness compliance plan based upon the issuance of the PCA Directive.
3/02/01	Superior amends its 12/31/00 TFR to reflect a $270 million downward adjustment of the OC account.
3/14/01	OTS conducts an off-site monitoring examination to review the recent changes in Superior's capital, earnings, liquidity, and sensitivity positions. CAMELS ratings 5/5NN552.
3/14/01	Superior submits a capital plan to OTS.
3/19/01	OTS and FDIC conduct a safety and soundness examination which includes a visit to Fintek in Orangeburg, New York. An in-depth review of Fintek's asset valuation model and the performance of the loans underlying the securitizations reveals that credit loss and discount rate assumptions are not adequately supported. An additional $150 million write-down of the residual assets appears warranted at 12/31/00. Examiners determine there is a $36.7 million receivable owed to Superior by CCFC, which represents a transaction with affiliates violation. CAMELS Ratings: 5/554544. Exam completed 07/09/01.

3/30/01	CCFC makes a temporary capital infusion to keep Superior above the "critically undercapitalized" PCA category by down-streaming its beneficial interest in $81 million of residual assets.
4/30/01	Superior submits an amended capital plan.
5/7/01	OTS demands that CCFC repay the $36.7 million receivable owed to Superior.
5/15/01	Superior submits a second amended capital plan to OTS.
5/18/01	Superior submits a third amended capital plan to OTS.
5/24/01	OTS issues an IMCR Directive that allows the thrift to hold less capital than the requirements established under PCA.
5/24/01	OTS conditionally approves Superior's capital plan.
5/24/01	OTS issues a PCA directive that incorporates the provisions of the earlier PCA directive and gives OTS enforceability of the capital plan.
7/16/01	Pritzkers inform OTS that they are not prepared to support the capital plan because future cash flows from Superior's residual assets will be materially less than projected in the plan.
7/24/01	OTS deems Superior to be "critically undercapitalized" and authorizes a formal examination and investigation into matters at Superior, its holding companies, and its external auditors.
7/25/01	OTS recommends the appointment of FDIC as conservator or receiver for Superior, and Superior's Board consents. OTS deems Superior to be insolvent based on the results and required adjustments of the 3/19/01 examination and the failure to implement the capital plan.
7/27/01	OTS appoints FDIC as receiver for Superior.

Allowance for Loan and Lease Losses	A valuation reserve established and maintained by charges against a bank's operating income. As a valuation reserve, it is an estimate of uncollectable amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected.
Asset Quality	The quantity of existing and potential credit risk associated with the loan and investment portfolio, other real estate owned, and other assets, as well as off-balance sheet transactions.
Brokered Deposits	Funds, which a bank obtains, either directly or indirectly, by or through a broker, for deposit into a deposit account. Brokered deposits include both those in which a single depositor holds the entire beneficial interest and those in which the deposit broker sells participations to one or more investors. Under 12 CFR. § 337.6, only "well capitalized" banks may accept brokered deposits without FDIC approval.
CAMEL/ CAMELS	The OTS and other bank regulators use the Uniform Financial Institution Rating System to evaluate a bank's performance. CAMEL is an acronym for the performance rating components: Capital adequacy, Asset quality, Management administration, Earnings and Liquidity. An additional component addressing Sensitivity to market risk was added effective 1/1/97. CAMELS.
Capital Markets	Includes investments such as mortgage-backed securities, dealer activities, foreign exchange, off-balance sheet items and other related activities.

Cease & Desist Order	A formal enforcement action issued by the OTS to a thrift to stop an unsafe and unsound practice or violation of a law or regulation pursuant to authority under 12 USC §1818. A Cease & Desist Order is terminated when the thrift's condition has significantly improved and the thrift has substantially complied with its terms.
Individual Minimum Capital Requirement	OTS may establish the minimum level of capital for an association at such amount or at such ratio of capital to assets as the OTS Director determines to be necessary or appropriate considering the particular circumstances of the association. This enforcement action is a special capital requirement set case-by-case for associations with unacceptably high-risk profiles.
Informal and Formal Enforcement Actions	Informal enforcement actions are documents that provide a bank with guidance and direction in addition to that provided by the Report of Examination. Informal actions are those instances where it is desirable to have written commitments from a bank's management and board of directors. Formal enforcement actions are reserved for significant safety and soundness or compliance problems that, unless corrected, constitute a present or future threat to the survival of the bank or otherwise pose a serious threat to the bank's safety and soundness.

Prompt Corrective Action	A framework of supervisory actions for insured thrifts, which are not adequately capitalized. These actions become increasingly severe as a thrift falls into lower capital categories. The capital categories are: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized (12 USC § 1831o).
Securitization	The process by which loans with similar characteristics are pooled and reconstituted into securities that may then be sold to investors.
Subprime	The term refers to the credit characteristics of the individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.
Thrift Financial Report (TFR)	This report collects detailed information to provide consistent and uniform information on all savings associations, to facilitate supervision by OTS, and to collect uniform information on industry activities. Each insured savings association is required to file the TFR with its regional office quarterly. The TFR discloses the savings association's financial condition, the results of its operation, and other supplemental data.

Appendix 6
Management Comments

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, DC 20552 • (202) 906-6590

James E. Gilleran
Director

January 31, 2002

MEMORANDUM FOR: Jeffrey Rush, Jr.
Inspector General
Department of the Treasury

FROM: James E. Gilleran
Director

SUBJECT: Draft Audit Report on the Material Loss Review of Superior Bank, FSB

We received your draft audit report entitled *Material Loss Review of Superior Bank, FSB* on January 25, 2002. We appreciate the opportunity to review the draft and provide these comments.

Though costly, Superior's failure is also instructive. In our view, the draft report generally presents a balanced and thorough discussion of the facts surrounding the failure of Superior and OTS's supervision of Superior over the last several years. We will pay particular attention to the draft report's observations about more vigorous oversight of management and auditors of institutions with a high amount of residual assets. We are always looking for ways to improve our supervision of thrifts, and your thoughtful report will help us identify areas in which we can perform this function more effectively.

The draft report makes several recommendations designed to improve OTS's supervision of institutions with high-risk activities. Specifically, you recommend that OTS take the following actions: issue further detailed guidance on third-party service providers; assess the adequacy of existing monitoring controls over examinations of thrifts whose critical functions are geographically dispersed, and provide for additional quality assurance reviews of these examinations; require that quality assurance reviews cover examinations where an expanded review of the external audit workpapers would have been warranted; reassess existing examination guidance on the proper application of new accounting pronouncements and standards; establish minimum testing procedures regarding valuation policies and practices for residual assets; ensure that planned quality assurance reviews of examinations cover the adequacy of examiner follow-up on previously reported problems; assess whether further enforcement action should be pursued regarding Superior's apparent violation of a restriction on paying bonuses in 2001; assess whether existing supervisory controls adequately ensure that

thrifts comply with Prompt Corrective Action (PCA) restrictions; and seek through interagency deliberations the need for legislative revisions to PCA with respect to brokered deposit restrictions.

We agree with the draft report's recommendations and intend to implement them within six months. In August 2001, in connection with our own internal review, OTS staff began working on a number of initiatives that are consistent with your recommendations. Beginning immediately, we will ensure that your recommendations that have not been previously addressed by our internal projects are implemented. We believe that these initiatives will improve OTS's supervision of the thrift industry.

In addition to our internal initiatives, OTS has worked closely with the other federal banking agencies to ensure that we maintain a high level of communications and coordination. To this end, an interagency agreement among the federal banking regulators was finalized on January 29th. This new policy makes several major improvements in this area including allowing the FDIC to examine any insured institution with a CAMELS rating of 3, 4 or 5 and to examine any PCA undercapitalized institution.

Again, thank you for the chance to review and respond to the draft report. My staff has provided technical comments directly to the audit team members.

Appendix 7
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Office of the Assistant Secretary for Public Affairs
Office of the Assistant Secretary for Financial Institutions Policy
Office of Strategic Planning and Evaluations, Departmental Offices
Office of Accounting and Internal Control, Departmental Offices

Office of Thrift Supervision

Director
Regional Director, Central Region
Audit Liaison

Office of Management and Budget

OIG Budget Examiner

U.S. General Accounting Office

Comptroller of the United States

Federal Deposit Insurance Corporation

Chairman

Office of Inspector General

February 6, 2002
Audit Report No. 02-005

Issues Related to the Failure of Superior Bank, FSB, Hinsdale, Illinois

OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDITS

Feb 7-6

FDIC
Federal Deposit Insurance Corporation
801 17th Street, N.W., Washington, D.C. 20434 Office of Inspector General

February 6, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In response to your August 1, 2001 request, my office has completed a review of issues related to the failure of Superior Bank, FSB. Our report provides an independent assessment of Superior Bank's failure and includes responses to the nine specific topics you raised in your request letter.

The failure of Superior Bank was directly attributable to bank management and the board of directors ignoring sound risk management principles and failing to adequately oversee Superior operations. Specifically, these bank officials:

- permitted the institution to concentrate its business too heavily in high-risk assets (residual assets resulting from Superior's securitizing or reselling loans, a detailed explanation of which is provided in our report) without maintaining adequate financial resources to withstand potential losses;
- used unrealistic and overly optimistic assumptions to record the value of residual assets in the institution's accounting records;
- supported liberal interpretations of accounting principles that enabled the institution to recognize enormous gains on sales of residual assets and report impressive net income figures that masked the net operating losses the institution was actually experiencing; and
- paid dividends and executed other transactions that benefited Superior's holding company but further depleted the institution's capital.

Superior's external auditors, Ernst &Young (E&Y), rendered unqualified opinions every year from 1990 through 2000 and supported the bank's valuations of residual assets and its methodology for calculating gains on sales of those assets. Even after the regulators began questioning the valuations in January 2000, the firm steadfastly maintained that the bank was properly valuing the assets in accordance with accounting principles. It was not until 1 year later that E&Y reversed its position and agreed with the regulators' opinion that the value of the residual assets should be adjusted to comply with those same principles—requiring a $270 million reduction in the bank's accounting records. The regulators later identified $150 million more in write-downs to the residual assets so their value would be fairly presented. Once these accounting adjustments were made, Superior was deemed insolvent.

Further, in our opinion, E&Y did not:

- encourage certain disclosures in the bank's financial statements that would have been expected under the circumstances,
- perform sufficient tests and other procedures to ensure the proper valuation of residual assets on the bank's accounting records, and
- identify or disclose a significant misstatement of Superior's loan loss reserves.

While Office of Thrift Supervision (OTS) examination reports identified many of the bank's problems early on, OTS did not adequately follow up and investigate the problems, particularly the valuation of residual assets carried by the bank. OTS appeared to rely mostly on representations made by the bank and validated by E&Y. OTS also placed undue reliance on the ability of the wealthy owners of the bank's holding company to inject capital if it was ever needed. However, when an injection of capital was needed in 2001, the owners agreed to but subsequently did not provide the necessary capital. Warning signs were evident for many years, yet no formal supervisory action was taken by OTS until July 2000, which ultimately proved too late.

Coordination between regulators could have been better. OTS denied a request by the Federal Deposit Insurance Corporation (FDIC) to participate in the January 1999 examination of Superior. Instead, OTS allowed the FDIC to meet with the OTS examination team off-site to discuss concerns approximately 1 week before the end of the examination. FDIC regional management did not raise this issue to the FDIC Board of Directors to gain access through the FDIC's special examination authority. OTS and the FDIC did work together in the January 2000 examination and more clearly identified the problem with the residual asset valuations. Even then, however, the regulators initially relied on bank management and E&Y assurances that the bank was properly accounting for its securitization activities and did not immediately put a halt to these transactions to the detriment of Superior.

The early intervention provisions of Section 38 of the Federal Deposit Insurance Act, commonly referred to as Prompt Corrective Action (PCA), require regulators to address problems before the financial condition of a failing institution deteriorates significantly. PCA did not work in the case of Superior. The capital ratios at Superior did not accurately reflect the financial position of the institution because the ratios were based on inflated asset valuations. In addition, beginning with OTS's 2000 examination, we believe that OTS used a methodology to compute Superior's capital that artificially increased the capital ratios, thus avoiding provisions of PCA. By using a post-tax capital ratio for the first time that we were able to determine, Superior was classified as "adequately capitalized." If a pre-tax calculation had been used, Superior would have been "undercapitalized," thus more immediately subjecting Superior to various operating constraints under PCA. These constraints may have precluded Superior management from taking actions late in 2000 that were detrimental to the financial condition of the institution.

The federal banking agencies have attempted to address these PCA issues through the adoption of risk-focused examination programs and risk-based capital requirements. In addition, on November 29, 2001, the agencies issued a new rule that changes, among other things, the regulatory capital treatment of residual interests in asset securitizations. The rule, which became

effective on January 1, 2002, addresses the concerns associated with residuals that exposed financial institutions like Superior Bank to high levels of credit and liquidity risk.

Our review identified other areas in which we believe regulatory oversight could be strengthened. Specifically, the bank regulatory agencies should focus attention on policies and procedures for:

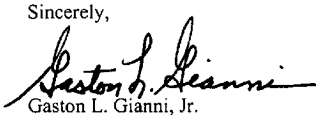
- reviewing external auditors' working papers for institutions that operate high-risk programs, such as subprime lending and securitizations;
- following up on warning signs that indicate possible fraud or other irregularities;
- consulting with other regulators when they encounter complex assets such as those at Superior Bank; and
- following up on previous examination findings and recommendations.

In a related vein, we will be issuing an audit report in the near future that discusses in detail restrictions that have been placed on the FDIC's use of special examination authority as we believe occurred at Superior. We note in the report that the FDIC's Board of Directors recently authorized an expanded delegation of authority for the FDIC to conduct examinations, visitations, or other similar activities of insured depository institutions. The delegation also implemented an interagency agreement that outlines the circumstances under which the FDIC will conduct examinations of institutions not directly supervised by the FDIC. While this agreement represents progress for better interagency coordination of examination activities, we are concerned that limitations remain that may impede the FDIC's ability to independently assess risks to the insurance funds.

Accordingly, in our report, we are recommending that the FDIC take actions to strengthen its special examination authority, primarily by seeking a legislative change to vest special examination authority in the FDIC Chairman. In addition, we will be recommending that the FDIC take the initiative in working with other regulators to develop a uniform method of calculating the relevant capital ratios to determine an insured depository institution's capital category for PCA purposes.

I appreciate the opportunity to respond to the Committee's concerns regarding the failure of Superior Bank. If I can be of further assistance, please contact me at (202) 416-2026.

Sincerely,



Gaston L. Gianni, Jr.
Inspector General

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INTRODUCTION

We conducted this review at the request of Senator Paul S. Sarbanes, Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. In his August 1, 2001 letter on the July 2001 failure of Superior Bank, FSB (Superior), the Chairman requested the Federal Deposit Insurance Corporation (FDIC) Inspector General (IG) to review why the failure of Superior Bank resulted in such a significant loss to the Savings Association Insurance Fund administered by the FDIC and requested that we make recommendations for preventing any such loss in the future. The Chairman also raised a number of concerns pertaining to the bank's failure and actions taken by the federal regulators, including nine topics he asked the IG to specifically address. In addition, the Chairman requested similar reviews from the Inspector General of the Department of the Treasury, who has responsibility for conducting audits of the Office of Thrift Supervision (OTS),[1] and the Comptroller General of the United States, who supervises the U.S. General Accounting Office (GAO).

This report presents the results of our review, which was conducted independently of the reviews performed by the Treasury Department Office of Inspector General and GAO. To facilitate reader access to our observations and conclusions, we have structured our report into the following sections:

1) Results in Brief -- presents an overview of this report,
2) Background -- presents a historical perspective of Superior, and
3) Topics Requested by the Chairman -- presents a detailed response to each of the nine topics requested by Senator Sarbanes. Each section is designed to stand alone; therefore, there may be occasional repetition within the various topics due to their inter-related nature.

At the conclusion of this report, we have included a glossary and several appendixes, which provide additional information on the issues presented in this report.

RESULTS IN BRIEF

The failure of Superior Bank was directly attributable to the Board of Directors and executive management ignoring sound risk diversification principles as evidenced by excessive concentrations in residual assets[2] related to subprime[3] lending. This risk was

[1] The OTS was the primary federal regulator for Superior. In this capacity, the OTS was responsible for conducting the regular examinations of the institution.

[2] In Superior's case, the residual assets consisted of two distinct parts. The first part was the residual interest that represented excess cash flows from the difference between the interest rates charged on the loans, which served as collateral for the securitizations, and the interest rate paid on the securities. The second part consisted of an overcollateralization account. Refer to Topics 2, 4, and Appendix B for a more detailed discussion of these two accounts.

[3] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

compounded by Superior's use of flawed accounting methodologies and unrealistic valuation assumptions, which were validated by its external auditors, Ernst & Young (E&Y). As a result, the true financial condition of Superior was not apparent while the bank reported inflated net income and capital levels from 1993 until it failed. Superior reported over $430 million of net income from 1993 though 1999 derived mainly from the valuation of the residual interests Superior retained when it securitized and sold its subprime loans (residual assets). Most, if not all, of this income was overstated. During this same time frame, Superior paid out approximately $200 million in dividends.

Ultimately, at the conclusion of its January 2000 examination, OTS instructed Superior to revalue the residual assets and downgraded the rating of the institution. In the months following the examination, Superior management:

1) did not implement OTS instructions to correct accounting irregularities;
2) continued providing erroneous Thrift Financial Reports to OTS;
3) sold loans to its holding company at less than fair market value, allowing the holding company to make an immediate profit of $20.2 million; and
4) extended credit to affiliates, which when added to the above loan sale to the holding company, totaled $36.7 million.

The actions of the Board and executive management resulted in the transference of funds to holding companies, also owned by Superior's owners, at the expense of the institution's capital. This transference had the effect of unduly enriching those companies and, potentially, their owners.

Once the residual assets were appropriately calculated and valued by regulators and by an outside party, the true financial condition of Superior was determined and the bank was declared insolvent. The Office of Thrift Supervision (OTS) closed the institution and appointed the FDIC as receiver on July 27, 2001. The failure resulted in FDIC recording an estimated loss of $426 million to the Savings Association Insurance Fund (SAIF) at closure, out of an estimated range of $426 - $526 million.

In addition to the roles played by the Board of Directors, executive management, and E&Y, the failure of Superior Bank is attributed to the following:

- OTS not aggressively limiting the risk assumed by the bank,
- Limited cooperation among federal regulators, and
- Untimely and ineffective Prompt Corrective Actions (PCA).

Ineffective Board of Directors and Executive Management

The Board of Directors did not adequately monitor on-site management and overall bank operations. In particular, the board:

1) did not establish adequate risk management and diversification policies and procedures,
2) disregarded supervisory recommendations and criticisms,
3) failed to ensure the bank's adherence to all laws and regulations, and
4) was dominated by the Chairman, who pursued actions contrary to OTS positions.

Superior's management apparently either misunderstood or disregarded the risks associated with the securitization process and the methods to control those risks. Superior's management operated a high-risk business, which entailed aggressively making loans to people with poor credit histories (subprime borrowers) and then securitizing these loans. Superior retained the residual assets after the securities were sold to investors. (Refer to Topics 2, 4, and Appendix B for a more detailed discussion of residual assets.) Superior's board resisted setting limits on the amount of residual assets held by the institution, which allowed management free rein to expand this area beyond the safety net provided by Superior's capital base. Despite being primarily funded by deposits insured by the FDIC, the thrift did not operate within the typical parameters of insured depository institutions.

Executive management regularly disregarded examiner recommendations. From 1993 forward, Superior's management did not implement numerous recommendations contained in OTS examination reports. These recommendations included placing limits on residual interests, establishing a dividend policy that addressed paying dividends based on unrealized net income derived from residual interests, and correcting errors in the capital calculations and Thrift Financial Reports. Management did not make regulatory adjustments to the bank's records, write-down defaulted loans and receivables, or comply with the requirements of a supervisory corrective action addressing the valuation of certain residual assets.

The thrift also apparently violated Federal Reserve Act requirements by making uncollateralized extensions of credit totaling $36.7 million to its holding company and affiliates. The majority of these extensions of credit happened during the last quarter of 2000 after it became apparent there were no profits to support continued dividend payments. The extensions of credit resulted in part from Superior selling loans to its holding company at less than fair market value. Superior's holding company quickly resold the loans for a $20 million profit.

The bank was dominated by one individual - the Chairman of the Board of Directors. Although Superior's retail operation was located in the Chicago area, the Chairman worked in New York and was instrumental in developing and coordinating Superior's principal lines of business. He often asserted to OTS management and examiners that Superior's ownership would always stand behind Superior in the event it ran into

financial problems. According to OTS examiners, "he was a very persuasive person who knew the most about Superior's operations."

Reportedly, the Chairman pursued courses of action contrary to OTS positions. For example, during the October 2000 OTS field visit, the Chairman disagreed with regulators on accounting issues related to the valuation of certain residual assets. The Chairman adamantly supported Superior's accounting methodologies as properly applying Generally Accepted Accounting Principles (GAAP), and sanctioned overall business strategies that clearly ignored any avenues to diversify Superior's high-risk and volatile asset base. Subsequently, he resigned in January 2001 in the face of overwhelming evidence that Superior's accounting methodologies were flawed.

Improper Accounting and Inflated Residual Interest Valuations

The bank used liberal interpretations of Statement of Financial Accounting Standard (FAS) 125 supported by E&Y to book huge imputed gains. Superior made favorable assumptions about the future returns from pools of loans and then booked the entire "profit" up front. Although allowed under generally accepted accounting principles, this represents a significant difference from the way thrifts typically recognize loan income – accruing income over the life of the loan.

It appears OTS relied on accounting information provided by the bank and validated by E&Y. Not until the January 2000 examination and subsequent October 2000 field visitation did it become apparent to OTS that, from 1993 forward, it may have relied too heavily upon Superior management's financial statements and E&Y's repeated unqualified audit opinions of those financial statements. The OTS did not determine the impact of the uncertainties over the accounting treatment accorded to Superior's residual interest assets until it was too late. When the OTS and the FDIC examiners reviewed E&Y working papers in 2000, they discovered that E&Y had made "fundamental errors" in the calculation of the value of the residual assets. Specifically, E&Y allowed the valuation of estimated cash flows on an accelerated basis even though the cash flows would not be received for several years. Because these cash flows were not properly discounted, and other valuation assumptions were not supportable, examiners determined that Superior's assets were over-valued by at least $420 million as of December 31, 2000.

On October 16, 2001, the Director of OTS testified before the Senate Banking Committee about the incorrect accounting treatment and unrealistic assumptions for valuing Superior's residual assets. "The risk from a concentration in residuals at Superior was exacerbated by a faulty accounting opinion by the institution's external auditors that caused capital to be significantly overstated, and by management and board recalcitrance in acting on regulatory recommendations, directives and orders," the Director said.

OTS Did Not Aggressively Limit the Risk Assumed by the Bank

While OTS examination reports identified many of the bank's problems early on, OTS did not adequately follow up and investigate the problems. As noted above, Superior

did not implement several OTS recommendations, which did not receive further attention from the OTS. OTS appeared to rely mostly on representations made by the bank and the opinions of its outside auditors. OTS also placed undue reliance on the ability of the wealthy owners of the bank's holding companies to inject capital if it was ever needed. However, when an injection of capital was needed in 2001, the owners did not provide the necessary capital. Many warning signs were evident as early as 1995, yet no supervisory corrective actions were taken until July 2000, which ultimately proved too late.

Examination reports dating back to 1993 indicated that OTS did not fully analyze and assess the potential impact of imputed gains on earnings and the institution. While OTS identified the volume of imputed gains recorded and noted that the gains were unrealized and subject to change, the OTS did not analyze and assess the bank's performance without those gains or on a realized cash flow basis. In effect, OTS placed undue reliance on unrealized income that was subject to significant market and economic volatility.

Limited Cooperation Among Federal Regulators

Coordination between regulators could have been better. Our analysis determined that the most critical lack of coordination and communication between the OTS and the FDIC was prior to the January 1999 safety and soundness examination when OTS would not allow the FDIC to participate on-site at the examination. Although the FDIC has authority under section 10(b)(3) of the Federal Deposit Insurance Act to conduct a special examination of any insured depository institution, there are required procedures that can inhibit timely and justified access. When OTS did not agree to let the FDIC participate in the 1999 examination of Superior, the issue was not raised to the FDIC Board of Directors for consideration. Had the FDIC participated, the two regulators working together may have been more effective in minimizing losses to the SAIF.

Untimely and Ineffective Prompt Corrective Actions

The early intervention requirement of the law allowing regulators to address problems before the franchise value of a failing institution deteriorates significantly, did not work at Superior Bank. PCA provides regulators with expanded supervisory powers to prevent an institution from becoming critically undercapitalized. For those institutions that do not meet minimal capital standards, regulators may impose restrictions on dividend payments, limit management fees, curb asset growth, and restrict activities that pose excessive risk to the institution. Unfortunately, none of this occurred at Superior until it was too late to be effective. The failure of Superior Bank underscores one of the most difficult challenges facing bank regulators today – how to limit risk assumed by banks when their profits and capital ratios make them appear financially strong. The federal banking agencies have attempted to address this challenge through the adoption of risk-focused examination programs and risk-based capital requirements. However, the recent failures of Superior Bank, First National Bank of Keystone, and BestBank demonstrate that further improvement is needed.

BACKGROUND

Acquisition of Lyons Savings Bank and Formation of Superior's Holding Companies

In December 1988, two wealthy families acquired Lyons Savings Bank, a Federal Savings Bank, Countryside, Illinois (Lyons) for $42.5 million, with assistance from the former Federal Savings and Loan Insurance Corporation (FSLIC). Lyons was a failing thrift institution with $1.5 billion in assets and $1.7 billion in liabilities. Lyons was renamed Superior Bank, Federal Savings Bank (Superior) in April 1989, with its home office located in Hinsdale, Illinois.

The two families formed three holding companies, Coast-to-Coast Financial Corporation (CCFC), Coast Partners (CP) and UBH, Inc. (UBH), for the purpose of acquiring and operating Superior. CCFC was owned by a complex set of companies/trusts controlled by the two families. Various holding company reports list nine affiliated higher-tier holding companies/trusts, including CP and UBH. CP and UBH were predominantly shell companies, each representing one family's interests and each with their primary activity the ownership of 50 percent of CCFC. CCFC, in turn, owned 100 percent of Superior as well as several other small financial services affiliates with operations that complemented Superior. In June 1999, CCFC established Superior Holdings, Inc. (SHI), as an intermediate holding company of Superior Bank and transferred the bank's common stock to SHI.

According to testimony presented by the Director of the Office of Thrift Supervision (OTS), the two families asked for and received a waiver in connection with the acquisition of Lyons from the former Federal Home Loan Bank Board of various filing and reporting requirements for all but three holding companies of the acquired institution - CCFC, CP and UBH. Only these three holding companies were required to file periodic reports and/or financial information. Throughout the history of Superior, OTS examinations indicated that the bank's only dealings with holding company affiliates involved either CCFC or its wholly-owned subsidiaries. As a result, OTS focused its holding company examinations of Superior on CCFC and its subsidiaries, including SHI.

During its first few years, Superior operated under a FSLIC Assistance Agreement. The agreement identified conditions of purchase whereby CCFC acquired Lyons with loss coverage and yield subsidies on certain covered assets. The loss coverage would reimburse Superior for certain losses incurred on these assets, and the yield subsidies guaranteed a certain rate of return on the covered assets. The covered assets initially included $565 million in assets, consisting principally of commercial real estate loans and investments in subsidiaries. The agreement concentrated management's efforts on resolving problem assets through asset sales and write-downs, and supporting claims under the agreement. By December 1992, most of the institution's problem assets were resolved and the effects of the FSLIC Assistance Agreement had diminished.

Superior's Shift to Mortgage Lending Operations

Starting in 1993, Superior's management began to focus on expanding the institution's mortgage lending business. The owners of CCFC founded a mortgage banking entity known as Alliance Funding Company, Inc. (Alliance) in 1985. In 1990, the owners contributed Alliance to CCFC. From January 1991 until December 1992, Alliance was owned and operated by CCFC and was an affiliate of Superior. Alliance specialized in originating and selling first and second home mortgage loans to non-conforming borrowers. In December 1992, CCFC merged Alliance with Superior and Alliance became a division of the institution. Superior entered the securitization arena in 1993 and, due to the incorporation of the mortgage company, Alliance was able to provide a supply of subprime residential mortgages for Superior to fund, package, and sell to parties who would complete the securitization process. As with most mortgage bankers, Superior was generally not holding these loans in its portfolio, but rather it was securitizing the loans. Superior, like many issuers, held on to the securities with the greatest amount of risk and provided significant credit enhancements[4] for the other securities.

Superior Bank's Securitization Process and Accounting

Superior Bank's process for securitizing and accounting for assets evolved from 1993 until its closure in 2001. (Refer to Appendix B for a general overview of the securitization process.) Prior to becoming a division of Superior, Alliance had several years' experience securitizing assets. Operating as a unit, Superior and Alliance used three different types of transactions in order to provide credit enhancements to achieve a AAA rating for their securitized products. The first two methodologies were used in the early years of the securitization process. The third form was used beginning in 1995 and continued until 2000.

First Methodology

The following information was obtained from a report prepared by Superior's Chairman of the Board. In 1993 and part of 1994, Superior's securitization process involved pledging a deposit account to assure the surety bond provider that sufficient funds would be available to achieve a zero loss assumption. The requirement for limiting potential losses through the use of a credit enhancement was necessary to attain a AAA rating. Superior deposited cash with a trustee who retained the funds in a short-term deposit account as pledged collateral for the securitizations. The excess spread was used to offset any losses in the underlying loans supporting the securitizations. According to this report from Superior's Chairman of the Board, accounting pronouncements did not require the value of the deposit account to be discounted. The report stated that at that time, Generally Accepted Accounting Principles (GAAP) required the pledging of assets to be disclosed in the financial statements; therefore, their availability was restricted because they were pledged. However, this transaction using the pledged deposit account was not

[4] A credit enhancement is a method of protecting investors from losses if the cash flows from the underlying loans are insufficient to pay the principal and interest due on the securities.

advantageous to Superior. The amount of loans supporting the security was equivalent to the outstanding securities. The interest income earned on the pledged deposit account was substantially less than the interest rate that was paid on the outstanding securities, which resulted in a disparity between the cash inflows and outflows. Since Superior was paying out more interest on the securities than the interest that Superior was receiving on the deposit accounts, this resulted in a negative impact on Superior's earnings.

Second Methodology

For the remainder of 1994, Superior used a junior/senior securitization structure. These transactions involved issuing AAA rated securities equal to approximately 90 percent of the underlying mortgages as senior bonds. The remaining 10 percent were issued as junior bonds with a potentially lower rating. The junior bonds became the credit enhancement for the senior issue. In other words, the excess spread[5] account and the junior bonds would absorb any losses up to the amount of the junior bonds issued before the senior class would suffer any loss. The excess spread account absorbed losses first. As long as the excess spread was sufficient to absorb the losses, there was little if any threat that the junior class would have to absorb any losses. Therefore, the junior class was only subject to nominal risk of loss. The junior bonds were either retained by the institution or sold to a third party at par.

If the junior class was retained by the institution, the report from Superior's Chairman of the Board stated that they did not require discounting since the financial statements reflected that they were pledged or subordinated to the senior class bonds. Also, if the bank retained the junior bonds, the interest earned on the underlying loans approximated the interest expense of issuing the junior bonds. Additionally, excess servicing collections, also known as the excess interest spread, were released to the institution each month, thereby increasing the institution's cash flow.

Despite the economical feasibility from a cash flow standpoint, the issuance of the junior/senior bonds required greater initial cash resources to fund since only 90 percent of the bonds were issued to third parties if the bank retained the junior portion. This structure was used in completing Superior's initial adjustable rate mortgage securitizations.

[5] The residual interests represent claims on the cash flows that remain after all obligations to investors and any related expenses have been satisfied. The residual interests represent funds required to build reserves and pay loan losses, servicing fees, and liquidation expenses. Any excess money, after all expenses have been met, provides a return to the holder of the residual interests. When the loans for the pools originate, they bear a stated interest rate. The securitized instruments are issued to investors at a lower rate than the stated rate on the loans. The difference between the rate that the loans are earning versus what the securitized pools are paying to investors is called the residual interest or excess spread.

Third Methodology

Superior began using a reconfiguration of the overcollateralization[6] (OC) account in 1995, replacing the first and second methodologies, and used this method until they ceased securitization activities in June 2000. In addition to the securitizing of the subprime residential mortgages, Superior began an automobile division in 1994. This division originated and securitized subprime[7] auto loans although on a much smaller scale than the operations of the mortgage division. The economies of the third accounting methodology afforded Superior the most advantageous method of increasing revenues through their securitization activities by permitting Superior to build the OC account incrementally over time with the excess interest they earned from the securitizations rather than establishing the bulk of the account at the onset of the transaction.

Superior's Securitization Process Using the Third Methodology

To begin the process, Superior and Alliance would either originate the loans, purchase them from brokers located throughout the United States, or use a combination of the two. Approximately 30 percent of the loans were generated in-house with the remaining 70 percent originated by brokers. Once an optimum level of loans was achieved, the loans were sold to a trust that would in turn finish the securitizing process. One of the factors contributing to Superior's expansion in the securitization arena was the inclusion of credit enhancements. Superior used the OC account and the residual interest as internal credit enhancements. An external credit enhancement Superior used was the mortgage pool insurance provided by Financial Guaranty Insurance Company. The insurance company would cover loan losses that exceeded a specified level in the securitization for a specified fee. In exchange for this guaranty, the insurance company would establish requirements, such as the establishment of internal credit enhancements, as part of the securitization agreement with the institution.

When the securitizing process was complete, the bonds were ready to be sold in the secondary market. The establishment and maintenance of the OC account began once the bonds were ready for sale. For example, if $100 million in bonds was securitized, the trust might issue only $98 million in bonds. The remaining $2 million in bonds established the OC account. In other words, the OC account represented the amount by which the collateral loan pool owned by the trust exceeded the outstanding Class A bond principal. In this example, the amount of the collateral loan pool owned by the trust would exceed the Outstanding bond principal by $2 million.

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[6] Overcollateralization is a type of credit enhancement in which the principal amount of collateral used to secure a given transaction exceeds the principal of the securities issued. As the term implies, the value of the assets collateralizing the securities issued exceeds the face value of the securities.

[7] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

Over the ensuing months, the excess interest spread[8], which normally would have been remitted to Superior, was transferred to the OC account. The excess spread was segregated in this account until a minimum percentage requirement was attained as specified in the securitization agreement between Superior and the surety or insurance company. The funds were then used to repurchase outstanding issues of the bonds. By retiring the bonds earlier, the OC account increased and less interest expense was paid on the outstanding bonds. After the required minimum level in the OC account was reached, the excess interest either reverted to Superior or was used either partially or in its entirety to repurchase additional outstanding bonds from the issue. If any losses on the underlying loans were incurred, either the excess interest spread or the collateral in the OC account was used to absorb the losses. If the OC account was required to absorb losses, which would reduce the balance in the account, the residual interests would be required to replenish the OC account.

The entire valuation process associated with securitizations is driven by assumptions. Since institutions cannot predict future events with 100 percent accuracy, they must make best estimates pertaining to the market forces that can affect the values of these instruments. For example, Superior securitized subprime mortgage and auto loans, which can present more risk than conventional loans. Therefore, an estimate of the potential loss rate would conceptually be higher than loss rates for conventional loans. Also, a review of the economic climate can give an institution information concerning the estimate of prepayments. If the economy is in a falling rate environment and the subprime borrowers are in the process of credit repair, they may be able to refinance their loans at a lower interest rate. This can result in higher prepayments in the securitizations. Superior had been in the securitizing business since 1993. Therefore, they had some historical experience with previous securitizations on which to base their estimates. This is not to say that all securitizations will behave in the same manner, it just provides a starting point to use for comparative purposes. The review of prior securitizations can assist in minimizing the principal risk associated with securitizations which is the failure of the anticipated future income to materialize due to changing market conditions or through the use of flawed or liberal assumptions.

Superior Bank's Demise

Superior aggressively expanded its asset base with a concentration of subprime securitizations. This resulted in Superior's recording large gains, which were not realized, but created the appearance of an increase in capital. In 1999 Superior decreased the discount rate used to value the residuals which served to overvalue the assets while at the same time relaxing credit standards that further increased the risk of non-payment of the loans underlying new securitizations. These actions served to worsen Superior's financial condition. Additionally, the regulatory authorities detected accounting inaccuracies, which resulted in a sizeable write-down to the overcollateralization account and the residual interests. The OTS and Superior attempted to arrive at a viable recapitalization plan; however, when the time came for the owners to implement the plan,

[8] The excess spread is the difference between the stated rate of return received on the loans and the stated rate of return paid on the securities.

they refused. On July 25, 2001, Superior's Board of Directors executed an Agreement and Consent to the Appointment of a Conservator or Receiver and on July 27, 2001 OTS appointed the FDIC as conservator and receiver of Superior.

The next section of this report presents a detailed response to each of the nine topics listed in Senator Sarbanes' request. This next section details the specifics relating to the examinations conducted by the OTS from 1993 through 1999, and the 2000 and 2001 examinations in which the FDIC participated. It also covers the accounting methodology used by Superior, the incorrect application of these accounting principles, an assessment of E&Y's auditing techniques, and the regulatory actions taken in response to the deteriorating condition of the institution.

TOPICS REQUESTED BY THE CHAIRMAN OF THE U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Topic 1 - The factors that ultimately resulted in the failure of Superior Bank.

There were three primary factors that led to the failure of Superior Bank including:

- The Board of Directors did not provide adequate oversight of Superior,
- Superior management's expansion of high-risk assets resulted in the depletion of the capital base, and
- The external auditors did not detect material misstatements resulting from improper accounting.

The Superior Bank Board of Directors was not receptive to the Office of Thrift Supervision's (OTS) regulatory recommendations for placing limitations on the excessive growth of residual assets[9] held by the institution. The board did not refrain from increasing the residual asset balance until the OTS issued a Part 570[10] directive in July 2000 requiring the institution to file a plan to cease their activities in this area. Superior Bank's management made a decision to expand the residual assets in 1993 at the onset of the securitization program. The inordinate growth of the residual assets until the restrictions were placed on the institution led to an excessive concentration in these high-risk assets. Problems were noted with Superior's high-risk lending program. Additionally, Superior could not support the assumptions pertaining to the discount rate at the 2000 examination. Despite the unqualified audit opinions from E&Y, during the October 2000 visitation the FDIC and OTS examiners determined that the accounting methodology applied to the overcollateralization (OC) account was incorrect. The effect of these two events, the overvaluation of the residual interests ($150 million) and the miscalculation of the OC account ($270 million), resulted in Superior suffering losses totaling approximately $420 million for these two accounts.

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[9] The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

[10] Part 39 of the FDI Act requires each appropriate federal banking agency to promulgate final regulations under this Act, which are safety and soundness standards. These standards encompass three broad areas including operational and managerial standards, asset quality, earnings, and stock valuation standards, and compensation standards. 12 CFR Part 570 and the guidelines in its appendixes were issued by the OTS as required by Part 39 of the FDI Act. This section addresses the submission and review of safety and soundness compliance plans and issuance of orders to correct safety and soundness deficiencies.

Failure of the Board of Directors to Provide Adequate Oversight of Superior

Despite warnings from the Office of Thrift Supervision (OTS), the board did not impose a limitation on the residual interests that Superior recorded. Superior embarked on the full-scale operation of the securitization business directed at borrowers with non-conforming credit histories in the first quarter of 1993 and added the subprime[11] automobile division in 1994. The OTS maintained an annual presence and conducted safety and soundness examinations each year at Superior from 1991 through 2001, with the exception of 1998. After Superior became involved in the securitization process in 1993, the OTS examiners recommended in 1994 that the board establish limits for the amount of securitizations that they would permit the institution to carry on its books. The OTS also indicated the potential risks associated with the increasing volume of residual assets. The OTS listed the residual assets as a concentration in their examination reports; however, they stated that their concern was mitigated due to Superior's capital levels. Management was permitted to continue adding these high-risk credit enhancements. The addition of residual assets was only curtailed when the OTS issued a Part 570 directive to Superior in July 2000 to formulate a plan to limit the residual interests to 100 percent of Tier 1 capital.

Superior was designated as a problem institution shortly after the January 2000 examination, in which the Federal Deposit Insurance Corporation (FDIC) participated, when its composite rating was downgraded from a composite "2" to a "4." The downgrade was attributable to Superior's high-risk lending activities. Another contributing factor was management's liberalization of the assumptions used in the valuation process following the January 1999 OTS examination. The examiners levied specific criticisms relating to the residual interests and the unrealistic assumptions that management used to value the assets. Also, there were numerous problems with the level of adversely classified assets[12], particularly in the auto division, and management's reflection of these assets in the Thrift Financial Reports (TFRs). The OTS, with FDIC participation, conducted a visitation of the institution in October 2000. Although bank management, on behalf of the board, informed the OTS that the deficiencies noted in the 2000 examination had been corrected, the visitation proved otherwise. Loss classifications that should have been charged-off were renamed and reclassified on the balance sheet. Some of the loss classifications had been eliminated; however, the overall corrective action taken in response to the reports was less than satisfactory. The board had failed its fiduciary responsibility to ensure that management abided by instructions given by the OTS.

Unsupported assumptions connected with the asset valuation problems continued into the 2001 examination. Large write-downs were required for the overcollateralization (OC) account and eventually for the residual interests. The institution was on the brink of

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[11] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

[12] Adversely classified assets are allocated on the bais of risk. Classifications are expressions of different degrees of risk of a common factor – the risk of repayment.

insolvency when the OTS issued a Prompt Corrective Action (PCA) Directive on February 14, 2001. The owners began negotiating for a recapitalization plan with the OTS. When the time came for the owners to implement the final plan and inject the necessary capital into the bank, the owners did not implement the agreement.

Superior's Management Decision to Expand High-Risk Assets Depleted the Capital Base

As mentioned above, Superior Bank began engaging in mortgage securitizations comprised of loans to borrowers with non-conforming credit profiles during the first quarter of 1993. Although the institution had several other divisions, such as the retail division that made more traditional types of loans, Superior adopted the securitization process as its primary business with a focus on mortgage lending. During 1994, Superior incorporated automobile lending into its securitizing activities. By June 1995, the residual assets became a concentration at the institution in excess of 100 percent of capital. As early as 1994, the OTS recommended that Superior's board place limits on the amount of residual assets that would be permitted in the institution. The board did not heed this recommendation and did not make any attempts to curb the growth of the residual assets until the OTS imposed a Part 570 directive in July 2000. (See Topic 2 for more details on the levels of concentrations and the valuation of the residual assets at various times during Superior's life.)

Beginning in 1998, Superior's management decided that they wanted to further expand this segment of their business. However, as they attempted to expand this area, the credit quality of the underlying loans in the securitizations began to deteriorate as evidenced by the increase in delinquency and loss rates. The growth coupled with management's liberal assumptions[13] enabled Superior to record a large income based on "gain on sale" accounting. These gains were imputed[14] and recorded; however, the bank had not received the cash finalizing the transaction. Based on the accuracy or inaccuracy of the assumptions, the income had not been realized even though it was recognized as a gain for financial reporting purposes. (Refer to Topic 5 for a detailed discussion of Superior's earnings.)

At the January 2000 examination, the examiners criticized the high-risk lending activities and downgraded the institution's composite rating to a "4." Additionally, liberal and unsupported assumptions used by Superior to value the residual interests were also criticized. The examiners questioned whether the provisions of Financial Accounting Standards (FAS) 125 were applied correctly to the OC[15] account. During a review of Ernst & Young's (E&Y) audit workpapers, a memo was discovered in the file that

[13] Assumptions must be made related to the loss rates, prepayment speeds, and discount rates in order to value the residual interests.

[14] Imputed gains are generated from the sale of securitized loans, and the calculations used to measure those gains are based on various assumptions and estimates that are subject to change.

[15] The overcollateralization account is a type of credit enhancement, which is a method of protecting investors from losses if the cash flows from the underlying loans are insufficient to pay the principal and interest due on the securities. Refer to Topics 2 and 4 for a more detailed discussion of the OC account.

indicated Superior had applied FAS 125 accurately. The OTS and the FDIC examiners accepted E&Y's conclusions. After the 2000 examination was completed, the institution's composite rating was downgraded due to various deficiencies including the high-risk lending program, the use of unsupported liberal assumptions associated with the residual interests, and the potential overvaluing of the OC account, all of which could have had a negative impact on Superior's capital position. At the conclusion of the examination, Superior was instructed to revalue the residual interests with supportable assumptions. By June 30, 2000, the residual assets equaled 345 percent of tangible capital. In July 2000, the OTS issued a Part 570 Directive which required the board to develop a plan in compliance with the OTS's Part 570 to reduce the level of residual assets to no greater that 100 percent of Tier 1 capital within a 1 year time period.

The OTS and the FDIC returned in October 2000 for a visitation to determine if the deficiencies noted in the 2000 examination were addressed and corrected. Instead of improvement, the examiners found that conditions were deteriorating. The examiners determined that the accounting treatment used to value the OC account was incorrect. It was during this visitation that the different perceptions of the valuation of the OC account among the examiners, E&Y, and the institution culminated. After numerous discussions between the institution, the regulators, and the accountants, it was decided that the accounting methodology was incorrect and the OC account was overvalued. E&Y conducted an analysis of the account and determined that the OC account and the residual interests would require substantial write-downs. The write-downs had a detrimental impact on Superior's capital position. The write-downs and losses, coupled with the owners' unwillingness to recapitalize the institution resulted in the OTS closing Superior on July 27, 2001.

External Auditors Failed to Ensure Proper Accounting

When Superior began the securitization process, the OTS evaluated the assumptions that Superior used at the OTS's annual examinations to validate the valuations. In 1996, the OTS brought in a specialist from its Southeast Region to review all of the residual interest assets. The examination reports reflected no deficiencies with the assumptions that Superior was using to value the residual assets. The 1997 and 1999 examination reports did not reflect any findings relating to the assumptions Superior was using. However, following the 1999 examination, Superior liberalized its assumptions, which increased the value of the residual interests.

When Superior initially recorded the residual interests, it used a 15 percent discount rate in the present value calculation to establish the value of the residual interests. In the January 2000 OTS examination, it was noted that Superior was using an 11 percent discount rate. Bank management indicated that the discount rate was reduced after the expected ongoing prepayment experience was more estimable. Management's change from 15 percent to 11 percent during 1999 created substantial additional value in the residual interests. Superior did not have adequate documentation to support this reduction in the discount rate. At the June 30, 1999 audit, E&Y, Superior's external auditors opined that the 11 percent discount rate was valid; however, the information that

the firm used to support this contention was stale. Additionally, E&Y only performed limited testing of the residuals. The OTS recommended that Superior revalue the residual interests using a 15-percent discount rate. The FDIC's Division of Resolutions and Receiverships personnel who reviewed the residual interests and their underlying loan pools after Superior was closed stated that a more accurate discount rate for these assets would be in the range of 20-25 percent.

The OTS and the FDIC regulators determined that the accounting methodology applied to the OC account was not correct. According to the OTS and the FDIC, E&Y misapplied the provisions of FAS 125 by not calculating present value to determine the value of the OC account. The Financial Accounting Standards Board issued "Question and Answer" guidance on FAS 125 in September 1998, December 1998, and in July 1999. The information in the December 1998 and the July 1999 guidance supported discounting the value of credit enhancements for the period in which the funds are restricted. According to the securitization agreements, the OC account was restricted and the funds were not immediately available to Superior. The OC account was to be released incrementally over the life of the securitization. Therefore, the OC account should have been discounted to reflect this period in which the account balance was restricted and not available for Superior's use. This methodology is in keeping with "cash-out" accounting, which requires the discounting of the value until the funds are released to the entity. Conversely, "cash-in" accounting does not require the discounting of the value since the funds are not restricted and are immediately available. Superior was applying the cash-in accounting methodology to value the OC account even though the funds were not available to the institution upon collection. (Refer to Topics 2 and 5 for detailed discussions of the misapplication of FAS 125.)

A series of disagreements ensued among the federal banking regulators, bank management, and the external auditors, which was drawn out until January 11, 2001 when the issue was resolved. At that time, a national partner of E&Y decided that the regulators were correct in their assessment of FAS 125 and the institution and the regional partner of E&Y were incorrect in their interpretation and application of FAS 125.

E&Y revalued the OC account and residual interests. Based on a revaluation of the residual interests and their related accounts, Superior suffered extreme depreciation in these assets, which adversely affected the institution's capital level. The approximate adjustments for the two accounts totaled $420 million, with a $270 million reduction to the OC account and a $150 million write-down to the residual interests. Based on the remaining business activities, Superior could not rebound from the deficient capital level it had sustained from the securitization activities.

Topic 2 - The levels of concentration and amount of valuation in residual interests held by Superior and the treatment of the residuals by OTS.

Once Superior began its securitization process, the levels of this activity expanded rapidly. From 1995 until the institution closed, concentrations of residual assets exceeded 100 percent of Superior's capital. The Office of Thrift Supervision (OTS) had an annual presence in the institution, with the exception of 1998, and conducted safety and soundness examinations each year. The OTS used capital markets specialists to review the securitizations beginning in 1996. Because of the external auditors' misapplication of Financial Accounting Standards (FAS) 125 and the institution's use of liberal assumptions to value the residual interests, the residual interests and the overcollateralization (OC) accounts were overvalued, which in turn overstated the capital of the institution. The valuation of the residual interests was questioned at the January 2000 examination. Once the overvaluation of the residual interests and the overstatement of the OC account were confirmed during the October 2000 visitation and the March 2001 examination, the true state of Superior's capital deterioration became evident.

Superior Bank Engages in the Securitization Business

Superior Bank adopted the securitization of residential mortgages to borrowers with non-conforming credit histories as its primary business after the incorporation of Alliance Funding Company, Inc. (Alliance), a former affiliate, as a division of Superior. The incorporation of Alliance as a division of Superior occurred on December 1, 1992. When Alliance was an affiliate of Superior, it specialized in originating, purchasing, and selling first and second home mortgage loans to non-conforming borrowers. Alliance operated through a network of 968 brokers located throughout the United States. The addition of Alliance as a division of the institution brought additional expertise and personnel to enable a rapid expansion in this market niche.

In 1994, Superior expanded its subprime[16] securitization activities to incorporate subprime automobile lending and securitization. This activity was not pursued as aggressively as the mortgage securitization. Therefore, the total dollar volume from the automobile securitization activities was nominal in relation to the mortgage securitization activities.

[16] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

Although concentrations of residual assets[17] were noted in Office of Thrift Supervision (OTS) Reports of Examination, in 1998 Superior began to rapidly expand its efforts in the subprime securitization market.

Residual Interests – A By-Product of the Securitization Process

Various types of financial instruments may arise as a result of the securitization process. One of these is a class known as residual interests. The residual interests represent claims on the cash flows that remain after all obligations to investors and any related expenses have been satisfied. The residual interests represent funds required to build reserves and pay loan losses, servicing fees, and liquidation expenses. Any excess money, after all expenses have been met, provides a return to the holder of the residual interests. When the loans for the pools originate, they bear a stated interest rate. The securitized instruments are issued to investors at a lower interest rate than the stated rate on the loans. The difference between the interest rate that the loans are earning versus what the securitized pools are paying to investors is called the residual interest. Residual interests may be retained by the sponsors of the securities or sold to investors in the form of securities known as interest-only strips. Superior retained the residual interests from its securitizations. The problems for Superior began when they amassed large quantities of these high-risk assets.

Accounting for Superior Bank's Securitizations

Because residual interests were not common in the financial markets, information on default rates, discount rates,[18] and prepayment rates of securitizations consisting of subprime loans was not readily available for comparative purposes. Unexpected market events can dramatically affect the discount rates or the default rates, thereby affecting the value of the asset and impairing the collectability of the future income stream. The use of liberal and unsupported assumptions can result in inaccuracies in financial statements and require material write-downs of the residual interests.

Superior recorded the values of the residual interests using a cash flow model. The cash flow model was based on assumptions, including discount rates, default rates, and prepayment rates, that Superior made concerning the portfolio of subprime loans underlying the securitized assets. In the 1993 through the 1999[19] Reports of Examination, the OTS did not take exception to the assumptions that Superior used since they appeared to be reasonable. However, following the January 1999 examination, Superior changed to more liberal assumptions. They lowered the discount rate used to

[17] The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

[18] A discount rate is an interest rate used to convert future receipts or payments to their present value.

[19] This includes all years except 1998, which is excluded since the OTS did not perform an examination of Superior in 1998.

value the residual interests, which in turn increased the value of the asset. Also, the revised prepayment and loss rates were not consistent with actual performance. At the conclusion of the January 2000 examination, the OTS was highly critical of the high-risk lending activities and the liberal and unsupported assumptions used by the institution.

Besides the regulatory criticism relating to the liberal assumptions used to value the residuals, Superior encountered other accounting difficulties. The Federal Deposit Insurance Corporation (FDIC) participated in the January 2000 examination with the OTS. Several capital markets specialists were in attendance from both agencies. The examiners questioned whether the provisions of Statement of Financial Accounting Standards (FAS) 125 were applied correctly to the overcollateralization (OC) account. Because of the institution's clean audit reports from Ernst &Young (E&Y), the examiners relied on E&Y's conclusions. After the 2000 examination was completed, the institution's composite rating was downgraded primarily because of the high-risk lending program, the use of the unsupported liberal assumptions associated with the residual interests, and the potential overvaluing of the OC account, all of which could have had a negative impact on Superior's capital position.

The OTS and the FDIC returned to the institution in October 2000 for a visitation to determine management's compliance with the January 2000 report recommendations. It was at this visitation that the different perceptions of the valuation of the OC account between the examiners, E&Y, and the institution culminated. In September 1998, December 1998, and July 1999, the Financial Accounting Standards Board Special Report issued "Question and Answer" guidance on FAS 125. The information in the December 1998 and July 1999 guidance, specifically question No. 75, supported discounting the value of credit enhancements for the period in which the funds are restricted. According to the securitization agreements, the OC account was restricted and the funds were not immediately available to Superior. The OC account was to be released incrementally over the life of the securitization. Therefore, the OC account should be discounted to reflect this period in which the account balance was restricted and not available for Superior's use. This methodology is in keeping with cash-out accounting, which requires the discounting of the value until the funds are released to the entity. Conversely, cash-in accounting does not require the discounting of the value since the funds are not restricted and are immediately available. Superior was applying the cash-in accounting methodology to value the OC account even though the funds were not available to the institution upon collection.

After numerous discussions between the institution, the owners, the regulators, and the accountants, it was decided that the accounting methodology was incorrect and the OC account was overvalued. E&Y conducted an analysis of the account and determined that the OC account would require a material write-down of $270 million to reflect the discounting that should have been applied in accordance with FAS 125. The residual interests also required a revaluation because Superior could not support their rationale for changing to more liberal assumptions. A substantial write-down of approximately $150 million was required to reflect reasonable assumptions associated with the residual interests. The write-down in the OC account had a significant detrimental impact on Superior's capital position as of December 31, 2000 rendering Superior significantly

undercapitalized for PCA purposes. The write-down required for the overvaluation of the residual interests was never reflected in the Thrift Financial Reports (TFR) because the bank and OTS were anticipating the implementation of a recapitalization plan.

Concentration Level and Dollar Amount of Superior's Securitization Activities

The following table details the concentration levels of the residual assets as a percentage of capital and their dollar volume as of financial statement dates at various OTS examinations.

Table 1: Concentration Levels and Dollar Volume of Superior's Residual Assets

Financial Statement Date	Residual Interests as a Percentage of Capital	Dollar Volume of Residual Interests
6/30/95	100.01% (1)	65.8 million
6/30/96	142.00% (1)	148.2 million
9/30/97	147.40% (2)	225.2 million
12/31/98	167.04% (2)	360.4 million
12/31/99	348.09% (3)	905.3 million
6/30/00	345.43% (2)	977.3 million
9/30/00	337.76% (2)	952.8 million
12/31/00	1,638.00% (1)	707.2 million
3/31/01	2,042.20% (1)	841.8 million

Source: OTS Reports of Examination, OTS October 2000 Field Visitation Report, and March 16, 2001 off-site examination memorandum
(1) Indicates core capital[20]
(2) Indicates tangible capital[21]
(3) Indicates equity capital[22]

OTS's Treatment of Superior's Residual Assets

The residual assets were the credit enhancements that Superior was obligated to provide through the securitization agreements in order to achieve a particular rating to enhance the marketability of the securitized bonds. From the onset of Superior's subprime securitizations, the OTS examiners noted in their examination reports the increasing levels in the residual assets retained by Superior; however, the OTS rated Superior a composite "1" or "2" from 1993 through 1999 despite the growing amount of these high-risk assets. Table 2 indicates the examination dates and the CAMEL(S) ratings assigned by the OTS. In cases where the individual components were not available, only the

[20] Core capital includes tangible capital and qualifying intangible assets.
[21] Tangible capital includes common stockholders' equity, additional paid-in capital, retained earnings, noncumulative perpetual preferred stock (less any contra accounts), pledged deposits, minority interests in the equity accounts of consolidated subsidiaries, and unrealized gains and losses on available for sale securities.
[22] Equity capital includes perpetual preferred stock, common stock, additional paid-in capital, unrealized gains and losses on available for sale securities, retained earnings, and other components of equity capital.

assigned composite rating is listed. An intervening downgrade assigned by the FDIC is also reflected in Table 2.

Table 2: Examination Ratings for Superior Bank, FSB

Regulatory Agency	As of Examination Date	CAMEL(S) and/or Composite Ratings
OTS	3/28/91	2
OTS	7/20/92	2
OTS	7/6/93	2
OTS	8/8/94	2
OTS	9/11/95	2
OTS	6/30/96	2
OTS	10/27/97	2-1-1-2-1/2
OTS	1/25/99	2-2-2-1-2-1/2 *
FDIC	Off-site monitoring in the 2nd Quarter of 1999	3-3-3-1-2-2/3
OTS	1/24/00	Final Rating: 4-3-4-2-2-1/4
FDIC	1/24/00	Final Rating: 4-4-4-3-2-1/4
OTS	3/19/01	5-5-4-5-4-4/5
FDIC	3/19/01	5-5-5-5-4-4/5

Source: OTS and FDIC Reports of Examination

* A sixth component, Sensitivity to Market Risk was added to the CAMEL rating. Refer to the Glossary for a complete definition.

The CAMEL(S) rating reflects the risks in financial institutions. Since Superior had such a large volume of high-risk assets, which affected every component of the CAMELS rating, a lower CAMEL(S) rating should have been assigned earlier to reflect this risk.

Treatment in the Early Years 1993 - 1999

As soon as Superior became involved in the securitization activities in1993, the OTS examiners were expressing their concerns for the level of residual interests and the additional risks posed by these instruments and their underlying mortgages. The 1993 report indicated that of the $10.87 million combined net income reported for the 6 months ending June 30, 1993, $8.1 million was generated through the mortgage banking area. The OTS Report of Examination recommended that Superior's Board of Directors establish limits for the amount of residuals that the institution would retain as a percentage of capital in order to contain the risk in the mounting asset. Also, the 1993 report instructs management that the residual interests were reported inaccurately[23] on the Thrift Financial Reports (TFR).

During the 1993 examination, the OTS cautioned that Superior should develop a comprehensive dividend policy addressing the impact of both cash and payment in kind

[23] Superior listed the residual interests on the TFRs as derivative securities. The OTS stated that they should be shown on the TFR as excess mortgage servicing rights.

dividends on all capital levels, with and without the book value of the residual interests. No mention of this recommendation was noted in subsequent examinations. In a December 21, 2001 OTS response to an FDIC Office of Inspector General (OIG) letter requesting clarification on several issues, the OTS stated that at that time, the Board promised to review the dividend policy and make any necessary changes by December 31, 1993. The OTS reiterated the need for a dividend policy in a February 8, 1994 meeting with Superior's management, who again stated that its intent was to submit a current dividend policy. A review of the OTS files indicates that a new policy was not submitted. Instead Superior continued to adhere to a dividend based on 50 percent of net income. The OTS stated that Superior's computation of net income followed Generally Accepted Accounting Principles (GAAP.) Also, based on Superior's reported financial condition, the requested amounts of the dividend payments fell within the OTS regulatory rules.

In 1994, the OTS Examiner-in-Charge (EIC) cautioned Superior about the increasing levels of residual interests. The board still had not established specific limits for the amount of residual interests. Additionally, management did not address the recommendation in the 1993 OTS examination regarding correctly identifying the residual interests on the TFRs. As a result, Superior was still submitting inaccurate TFRs to the OTS because the residual interests were misclassified on the TFRs. The 1995 examination noted that the amount of the residual interests now exceeded 100 percent of capital.

One of the most significant issues raised during the 1994 and 1995 examinations was Superior's erroneous calculation of the Allowance for Loan and Lease Losses (ALLL). The inclusion of a percentage of the ALLL in supplemental capital for purposes of assessing the bank's capital position makes the accuracy of the ALLL critically important. Depending on the amount in the ALLL, all or a portion of the ALLL up to 1.25 percent of risk weighted assets, is allowed to be included in supplemental capital. Superior's ALLL was comprised of three individual pieces. One portion provided for loss contingencies in the retail banking division. A second piece covered the volume of loans originated, securitized, and sold in the mortgage banking unit. The third piece was a valuation established to protect the institution from the devaluation of the residual interests due to fluctuations in the business cycle. The OTS Examiner-in-Charge (EIC) criticized Superior's inclusion of the third portion in the ALLL since it was not established because of credit conditions and should therefore be excluded from the ALLL. Because this portion was included, the ALLL was overstated which in turn overstated the capital level. Despite the second admonishment in 1995 for including erroneous amounts in the ALLL, Superior did not take affirmative action to correct the inaccuracies. No further mention was made of the inclusion of the inaccurate valuation amounts in the ALLL until the 2000 examination when massive adjustments were made to the account. The ALLL was detailed in the ensuing reports (1996 – 1999); however, the examiners did not mention or criticize the inclusion of erroneous valuation amounts. In the December 21, 2001 response from the OTS to the FDIC OIG concerning this issue, the OTS stated that at that time there was little guidance concerning the activities in which Superior was involved. According to the risk-based capital guidance, the loans

underlying the securitizations were required to be converted as if they were on-balance sheet equivalents. Because of this requirement, the OTS viewed the converted[24] off-balance sheet loans and the ALLL as if they were both items on the balance sheet at Superior. Future implementation guidance of FAS 125 issued in July 1998, December 1998, and July 1999 provided clarification on the accounting issues. At the January 2000 examination, it became clear to the OTS that the residual assets should be carried at fair value without the support of a reserve. At this time, Superior was required to net the interest rate risk and credit risk components of the reserve against the residual assets for TFR reporting purposes and exclude the remainder of the ALLL attributable to the residual assets from the risk-based capital calculations.

The OTS conducted an intensified examination of the securitization process in 1996. The OTS Washington Office enlisted the assistance of a capital markets specialist from the OTS Southeast Region to conduct the review of this area. The examiner thoroughly reviewed Superior's assumptions, which were used to establish valuations for the residual interests. At the conclusion of the examination, the OTS examiner stated that the valuations seemed reasonable, and no criticisms in this area were noted in the Report of Examination. The 1997 and 1999 examinations showed similar results. The regional capital markets specialists reviewed the securitizations and nothing extraordinary was noted. Overall, the EIC of both examinations indicated that no material supervisory concerns were noted and that overall risk management practices were satisfactory. The major concern was the level of the residual assets in relation to capital; however, the examiners' stated that their concerns were mitigated by strong capital levels. The 1997 and the 1999 reports, as well as subsequent correspondence did not indicate that the OTS took any actions to restrain Superior's level of residual interest assets.

After receiving and reviewing the OTS Report of Examination dated January 25, 1999, the FDIC believed that the OTS's composite rating of "2" was not representative of the risk posed by the institution. The FDIC evaluates the examination reports that are submitted by the other banking agencies to determine if the ratings reflect the risk in the institution in order to reduce potential losses to the funds. Because of the risk in Superior's securitizations, the level of repossessions, and the residual assets' inordinate size in relation to capital, the FDIC downgraded Superior to a composite "3" for risk-related insurance premium purposes. The OTS did not agree with the downgrade. The OTS thought that the FDIC's reasons for downgrading the rating were unsupported; therefore, the OTS thought that the rating change was too harsh.

Following the 1999 examination, Superior liberalized its assumptions for valuing the mortgage-related residual interests, thereby, increasing the value of the residuals.

Treatment in the Latter Years 2000 - 2001

The FDIC participated with the OTS in the 2000 examination. Numerous flaws were noted with the altered assumptions for valuing Superior's mortgage related residual

[24] This is a method used in the calculation of risk-weighted assets whereby the off-balance sheet items are multiplied by a risk factor that converts or transforms the risk into a balance sheet equivalent.

assets. There was no documentation, such as comparable industry figures, to support the newly implemented assumptions. The concentration of residual assets was escalating and the board had still taken no action to curtail the amount of residuals acquired by the institution. The OTS advised the board to adopt restrictions on the amount of residuals in relation to the capital protection. Additionally, adverse classifications attained an excessive level because of the high-risk lending program. Policies, including the classification and ALLL, needed revamping to include all significant institutional activities.

In 2000, the OTS recommended that management implement procedures to determine the fair market value of the residual interests and adjust the carrying values of these assets accordingly, since it appeared that write-downs might be necessary due to the use of the unsupported assumptions. The examiners from both agencies questioned the accounting associated with the OC account. A DOS examiner stated that the OTS was reassured by management that E&Y had expressed an unqualified opinion in the firm's audit reports, which included information pertaining to the accounting methodology for the OC account. Because of E&Y's clean audit reports, examiners from the FDIC and the OTS relied on E&Y's assessment of the validity of the OC account.

Also, the ALLL was grossly overstated due to the inclusion of valuations for the residual assets. The value of the ALLL was reduced from $128 million to $2.6 million at the conclusion of the 2000 examination to exclude ineligible funds that were in the ALLL. Additionally, the 2000 report disclosed that Superior was still incorrectly reporting the residual assets in the TFR. At the conclusion of the examination, Superior was accorded a composite rating of "4."

On July 1, 2000, because of the concerns noted at the January 2000 examination, the FDIC downgraded Superior to a category "C" for risk-related premium purposes. The OTS concurred with the reclassification. On July 5, 2000, the OTS issued to Superior a Notice of Deficiency and Requirements for Submission of a Part 570 Safety and Soundness Compliance Plan. The Part 570 directive was issued based on the results of the 2000 examination. The Part 570 directive required a plan outlining procedures for the revaluation and sensitivity testing of the residual assets. It also included provisions for the internal control function, credit underwriting standards, and the revision of the ALLL policy, including procedures to maintain the ALLL at a level commensurate with the risks at the institution. The directive also required Superior to formulate a plan to reduce its investment in residual assets to 100 percent of Tier 1 leverage capital within a year. This is the first documented evidence since the recommendation made in the 1994 OTS examination that the OTS placed any limitations on the extent of Superior's maximum involvement in residual assets. Superior submitted the compliance plan to the OTS on August 4, 2000.

To confirm whether Superior had implemented corrective measures stemming from the January 2000 examination report, the OTS scheduled a visitation in October of 2000 with FDIC participation. After reviewing the information on the OC account, both agencies determined that the accounting methodology was not correct and that the account was

overstated. E&Y and Superior's management disagreed with the examiners' assessment that the account was incorrectly stated. This was the beginning of a several month long controversy which was ultimately resolved by E&Y's New York National Office which agreed with the regulatory agencies in January 2001 that the accounting for the OC account was incorrect and adjustments were necessary to reflect the correct total.

The OTS, with FDIC participation, conducted an examination on March 19, 2001. Superior ceased its securitization activities and gain on sale accounting associated with the mortgage division on June 30, 2000. Because of the high level of risk and the disproportionate size of the residual assets in relation to capital, the examination focused on the residual assets that remained on the institution's books. After E&Y's New York Office agreed with the regulatory authorities, a $270 million write down was required to adjust the value of the OC account. This dropped the institution from its former status as a well and/or adequately capitalized institution to a significantly undercapitalized institution. Further, Superior was still unable to provide documentation to support the assumptions used to value the residual interests. The examiners calculated that additional write-downs of approximately $150 million would be required as of December 31, 2000.

Because of the required year-end adjustments for the OC account, but prior to the adjustment for the overvaluation for the residual interests, Superior was designated as "significantly undercapitalized" for PCA purposes. The OTS issued a PCA Directive to Superior on February 14, 2001 and a consent Cease and Desist Order to two of the holding companies, Superior Holdings, Inc. and CCFC, as of the same date. Superior was required to submit a Capital Plan by March 14, 2001. Superior met the deadline; however, the OTS did not consider the plan acceptable.

Capital problems resurfaced at the end of the first quarter of 2001 when expenses from discontinued operations threatened to lower Superior's capital designation to "critically undercapitalized." In April 2001, retroactive to March 31, 2001, CCFC injected $81 million in residual interests in order to avoid any further decline of Superior's capital level. This "injection" of residual interests further increased the holdings of Superior's residual assets and kept the institution above the critically undercapitalized benchmark for PCA purposes. The OTS responded to the FDIC OIG's questions regarding this issue in OTS's written response dated December 21, 2001. The OIG inquired why the OTS permitted Superior to count the residual interests towards their capital when the OTS Handbook specifically states that the inclusion of non-cash contributions as a source of capital is not an acceptable practice. The OTS responded by stating that the transaction was in conformance with GAAP. According to the OTS response, the OTS Handbook is only meant as guidance and is not an authoritative source; therefore, deviations from the handbook must be analyzed on a case by case basis. The contributed residual interests were part of Superior's proposed Capital Plan. Under the plan, the residual interests would be purchased from Superior by a special purpose vehicle. The residual interests would be converted into cash within 60 days of the Capital Plan's approval date. Therefore, the OTS did not disapprove the transaction.

Additionally, contrary to accounting standards, Superior netted certain assets and liabilities in order to reduce their totals, which in turn assisted in increasing their tangible capital ratios above the 2 percent threshold. The OTS responded to the FDIC OIG's questions regarding this issue in their written response dated December 21, 2001. In correspondence dated May 3, 2001, the OTS questioned whether Superior was using the right of setoff[25] properly. The examiners from both the OTS and the FDIC were to review this issue during the 2001 examination. An OTS memorandum indicated that it was unlikely that Superior should have used the right of setoff when filing the March 31, 2001 TFR. However, prior to any final determination on this issue, the OTS approved Superior's Capital Plan. At this time, the OTS's choice was to either implement the Capital Plan or place Superior into receivership. The OTS considered the right of setoff issue "somewhat moot."

The Capital Plan that the OTS conditionally accepted stated that the residual assets would be purchased by the holding company through a series of transactions including cash injections from the owners, third party financing, and the pledging of bank assets. The OTS did not require Superior to write down the value of the residual interests during the 2001 examination since the plan listed the sale price of the residual assets as $10 million over the book value. Additionally, the OTS did not require Superior to restate its March 31, 2001 TFR, which listed the residual interests at amounts exceeding their true value.

Other adverse examination findings in the March 2001 examination included out of balance accounts, an unsecured receivable from Superior's second tier holding company[26] and required reductions to servicing assets. The out of balance accounts consisted of two accounts entitled "Other Receivables." The first account consisted of deficiency balances on auto loans after disposal of the autos, plus losses on the sale of repossessed autos. Some of the items dated back to November 1999. The total loss in this account was $3.4 million. The second account consisted of an unreconciled difference from another general ledger account involving principal and interest advances on securities. The total loss on this account was $4.6 million. Beginning in April 1999, Superior had transactions with its second tier holding company, CCFC. At the 2001 examination, it was discovered that Superior had a receivable on its books from CCFC for $36.7 million. Superior sold loans to CCFC. CCFC in turn sold these loans for a $20.2 million profit. The bulk of the $36.7 million balance represented profits from the sale of loans by CCFC that were owed to Superior. The OTS listed this receivable as a violation between Superior and CCFC for engaging in transactions that were not at arms length and for extending unsecured credit to an affiliate. Lastly, Superior had advances related to six closed securities that should have been written off. The securities were called as of April 30, 1999 and Superior, as servicer, failed to collect the advances

[25] The right of setoff issue evolved from the sale of certain mortgage loans that were purportedly under commitment for sale to various financial intermediaries. FASB Interpretive Opinion No. 39 sets requirements in order to establish the right of setoff. The effect of the setoff is the reduction of certain assets by the corresponding amount of liabilities. This in effect, reduces the total assets and liabilities.

[26] CCFC transferred ownership of Superior to Superior Holding, Incorporated (SHI), which became Superior's first tier holding company. CCFC owned SHI and CCFC became Superior's second tier holding company.

totaling $4.9 million due from the trust. Additionally, the OTS criticized the unprofitable status of the institution.

According to the FDIC's draft March 19, 2001 Report of Examination, if all of the losses noted at the examination were charged-off and all adjustments were made, the institution was insolvent as of that examination. Because of the ongoing negotiations with the owners concerning the capital restoration plan, the OTS did not require Superior to charge-off the $150 million revaluation of the residual interests. The FDIC 2001 draft report was not finalized and remitted to the institution.

OTS Treatment of the Residuals - Subprime Automobile Loans

Superior expanded its market in subprime loans with the addition of subprime automobile lending in 1994. The first OTS exam after this business line became fully operational was conducted in 1997. This examination criticized management for omitting delinquent auto loans and repossessions in their TFRs.

At the 1999 examination, the OTS noted that the auto division had an unacceptable level of delinquencies and losses. Once again, management was criticized for excluding assets; which should have been listed as adversely classified assets on the TFRs. The OTS required Superior to establish specific valuation reserves for loss classifications totaling $12.5 million. The OTS recommended that management amend the classification system to ensure accurate regulatory reporting and establish all appropriate allowances. Additionally, the OTS recommended that Superior revise and expand the ALLL policy to cover all of the pertinent business of the institution.

The FDIC participated in the 2000 examination with the OTS. Adversely classified assets and higher than anticipated loss rates, which were more than double the original estimates, continued to mount in the automobile division. Superior was instructed to follow the *Uniform Credit Classification and Account Management Policy*, which had been adopted by all of the federal banking regulators.[27] (Refer to Topic 5 for additional information on the OTS's lack of enforcement of the requirements of this policy's guidelines at previous examinations.) The OTS also charged-off a $12 million asset swap between Superior and Western Trading, an advertising concern. Superior "sold" worthless auto loans, which should have been charged-off, for future advertising credits. Despite tightening lending standards twice and reducing the lending volume, the auto division was not profitable. The OTS again criticized management for incorrectly risk weighting assets associated with the automobile division for purposes of calculating risk-based capital. Superior's unsuccessful subprime automobile lending operations ceased in December 2000. Expenses associated with the disposition of this division continued to impair income in 2001.

[27] This policy was adopted by the OTS in 1987. However, OTS examiners in 1999 and 1997 did not use the policy to classify loans at Superior that fell within the scope of this policy. The OTS did not require Superior to follow the policy until the 2000 examination.

Topic 3 - The regulator's reliance on and oversight of accounting information provided by the institution and its external auditors.

The Office of Thrift Supervision (OTS) did not independently determine the value of Superior's residual assets – residual interest and overcollateralization accounts – or take enforcement action when its examiners found errors in Superior's Thrift Financial Reports (TFR). Instead, OTS relied on Superior's management and its external auditor, Ernst & Young (E&Y) for the valuations of significant assets. The OTS placed undue reliance on the unqualified opinions that E&Y gave on Superior's annual audited financial statements. Because of the high-risk nature of subprime[28] lending – Superior's principal line of business – OTS should have more closely scrutinized the value of Superior's residual assets and conducted more frequent reviews of E&Y's workpapers. In addition, OTS should have required Superior to file corrected TFRs when material errors were found, and taken enforcement actions against Superior and its management when Superior continued to file erroneous TFRs.

Reliance on and Oversight of Superior's External Auditor

Superior management, with the advice of its external auditor, Ernst & Young (E&Y), utilized accounting practices that made the institution appear more profitable than it was. This, in turn, enabled Superior to make substantial dividend payments in accordance with its dividend policy, take on more risk in the form of additional securitizations and deflect regulatory concern by holding out its overstated capitalization ratios and additional profitability. E&Y, the bank's external auditor from 1990 through 2000, gave Superior unqualified audit opinions and did not question the valuations or calculations involving Superior's assets and capital structure. Ultimately, in 2000, the OTS and the FDIC examiners questioned the incorrect calculation of the overcollateralization account and the valuation of the residual interests. After the January 2000 OTS examination, but before ceasing securitization activities on June 30, 2000, Superior increased the amount of risk in these assets.

E&Y Advised Superior's Audit Committee

According to minutes from an Audit Committee Meeting of Superior's Board of Directors held on January 27, 2000, E&Y's Engagement Partner (E&Y Partner) gave a summary of the audit results completed for the fiscal year ended June 30, 1999. E&Y Partner presented a package to the Audit Committee that identified E&Y's: audit

[28] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

approach, areas of audit emphasis, required communications, next fiscal year's audit approach, summary of emerging technologies and related risks, an overview of the audit process, and a summary of audit differences. The E&Y Partner went through each area identifying key points during the audit process. He also noted the various reports that were issued by E&Y as a result of the audit process and that all such issued reports contained audit opinion letters, which noted no exceptions.

Subsequent to the presentation by E&Y's Partner, a detailed discussion relative to financial receivables[29] (a/k/a residual interests) and the audit steps performed during the review processes by E&Y ensued between E&Y's Partner and an Audit Committee member. E&Y's Partner explained in detail the audit process and the testing techniques that E&Y utilized to evaluate the underlying assumptions and the model utilized by the bank. He also detailed that the firm's audit processes included a review of the bank's balance sheet carrying values of financial receivables and related assets, recoverability analysis of financial receivables, and the related income statement accounts. According to the January 27, 2000, meeting minutes, E&Y's Partner noted that, "E&Y had an overall comfort with the assumptions utilized by the Bank and the resulting values." E&Y's Partner noted that after running the firm's own model with varying assumptions to test the bank's model, "E&Y believes that the overall book values of financial receivables as recorded by the bank are reasonable considering the bank's overall conservative assumptions and methods." Clearly, as of June 30, 1999, E&Y concurred with the assumptions and the model used by Superior management to value the financial receivables.

Next, the Audit Committee and E&Y's Partner entered into a discussion relative to Statement of Financial Accounting Standards (FAS) 140 (FAS 140 replaced FAS 125[30] and became effective after March 31, 2001), which would be required to be utilized by the bank for the fiscal year 2001. It was noted that the primary effect of FAS 140 on the bank would be that it would require the bank to provide greater disclosures of the accounting assumptions it used to record the book value and related income of the financial receivables. The disclosure would require a comparison to actual results achieved, such as Constant Prepayment Rate (CPR)[31] speeds, discount rates, and loan loss reserve rates. According to the minutes, the bank's current model used a higher discount rate at inception and the ARM loan portfolio did not estimate the effect of using

[29] Financial Receivables is a term used by E&Y to describe a financial component of Superior's securitization transaction. Financial receivables, also known as residual interests in collateralized mortgage obligations, represent the net present value of future cash flows of the bank's residual interests from sales of loans over the estimated life of the loans. Expected net cash flows would be reduced to reflect adjustments for estimated prepayments, losses, and discounts at rate management believes to be similar to a yield required by a third party investor.

[30] FAS 125 was effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996 through March 31, 2001. FAS 140, a replacement of FAS 125 although most of its provisions are carried over into FAS 140, took effect after March 31, 2001.

[31] CPR = Constant Prepayment Rate. The percentage of outstanding mortgage loan principal that prepays in one year, based on the annualization of the single monthly mortality, which reflects the outstanding mortgage loan principal that prepays in one month.

a prepayment ramp[32] on the ARM portfolio. It was also noted that the overall discount rates being utilized by Superior, considering all factors, were comparable to current market discount rates used by other third parties.

In further discussing Superior's "conservative methods," E&Y's Partner noted that, "CPR factors, discount rates, loan prepayment fees and other conservative factors used by Superior may need to be reviewed and potentially adjusted to reflect current market factors to more closely track actual results under reporting required by FAS 125." Immediately following the Partner's caution were unattributed statements that implied that Superior did not have to worry about the impact of FAS 140 disclosure requirements. The minutes state, "However, it was further noted that based on an initial review, changes in these factors and methods would result in offsetting changes in reported values. Confirming the factors and methods used to facilitate the disclosure requirements of FAS 125 would likely result in the use of different assumptions without substantially changing the initial valuation recorded by Superior." We could not determine from reviewing the minutes whether E&Y's Partner or one of Superior's board members made the two statements.

As of January 27, 2000, E&Y took the position that Superior's accounting methodology and valuation assumptions for its financial receivables were in conformance with Generally Accepted Accounting Principles (GAAP) but might be impacted by FAS 140, which required additional disclosures in the financial statements.

OTS Reviewed E&Y's Workpapers

OTS's Regulatory Handbook, Section 350, Independent Audit, issued August 16, 1995, provides guidelines for examiners about the use of the external auditor's annual work. The annual external audit should be used to assist in the financial analysis of institutions to identify areas of supervisory concern or accounting complexity and to detect trends and information not otherwise revealed in the monitoring of institutions. The independent auditor performs procedures that evaluate the reliability of financial statement assertions and certain assertions included in the Thrift Financial Report (TFR). According to the AICPA's Statements on Auditing Standards (SAS), specifically SAS No. 31, Evidential Matter, audit objectives are established to test the numerous assertions (both implicit and explicit) that are included in a client's financial statements. These assertions can be grouped into the following five categories: existence and occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure.

Section 350 states that examiners should use the annual audit to supplement the examination process whenever possible. Examination personnel are encouraged to review the audit workpapers when planning examinations. The review is intended to help determine the scope of the examination, identify areas where examination procedures can

[32] The term is a concept often used with home equity loans and manufactured-housing transactions to describe a series of increasing monthly prepayment speeds, prior to a plateau, on which the expected average life of a security is based.

be supplemented by audit work, identify audit work that can be relied on for certain financial statement assertions, and identify high-risk areas that require expanded procedures. Examiners may rely on the audit work findings in low-risk areas. In such cases, examiners should request that the auditor provide copies of the key workpapers. In high-risk areas, examiners should use the audit evidence to plan and supplement examination procedures. Examiners should also consider exercising the OTS's authority to direct auditors to perform specific or additional audit procedures. In such cases, the regional accountant should be consulted.

OTS relied on accounting information provided by the bank and validated by E&Y. Not until the January 2000 examination and subsequent October 2000 field visitation did it become apparent to OTS that it may have relied too heavily upon Superior management's financial statements and E&Y's unqualified audit opinions of those financial statements. OTS did not detect the uncertainties over the accounting treatment accorded to Superior's residual interests and overcollateralization (OC) account early enough to correct the problem before Superior failed.

According to the OTS Chicago Regional Accountant, examiners conduct reviews of external audit workpapers to help them scope their examination and focus on the higher risk areas present in an institution. Examiners also try to eliminate areas or reduce the amount of work they would ordinarily do after determining the extent to which the external auditor conducted its audit. His explanation was in concert with Section 350 that states that after reviewing the auditor's workpapers, the examiner may decide to do some or all of the following:

1) reduce the scope of the examination in certain areas based on the extent, scope, and findings of the audit;
2) expand the examination scope in certain high-risk areas based on the audit work;
3) expand the scope in certain areas based on the auditor's findings that disclose matters of supervisory concern; and,
4) refer regulatory reporting issues to the regional accountant.

Section 350 provided the following examples of cases where a review of the audit workpapers and conversations with auditors could assist examiners in performing examinations.

1) An association has asset quality problems and reserves are deemed by the auditor to be adequate. The audit workpapers document management's valuation estimates and indicate the audit procedures performed to test those estimates. After the review, the examiner would understand management's approach and the exposure areas.

2) An association has aggressive accounting practices. The audit workpapers would document management's reasons for the aggressive practices. After the review, the examiner would understand management's rationale and could assess whether

a less aggressive accounting practice would be more appropriate from a safety and soundness standpoint.

3) An association has serious internal control problems. The full extent of the problems should be discussed with the auditor to determine where the scope of the examination should be expanded.

4) An association has mortgage servicing assets. The audit workpapers would document the assumptions and methodologies used to value the servicing. If the findings are acceptable for safety and soundness reasons, the examiner could rely on the audit work.

Of the four examples cited above, Superior exhibited characteristics cited in virtually all four examples. According to Section 350, a review of the audit workpapers and a discussion with the auditor in each of the above examples would likely improve the examiner's understanding of the differences in judgment or fact that might require examination adjustments to the TFR. They also illustrate how the examiner can focus scarce examination resources on problem areas by using some of the evidence gathered by the auditor.

OTS performed workpaper reviews in conjunction with the 1996 and the 2000 examinations and subsequent 2000 field visitation. During the 1996 workpaper review, OTS focused on Superior's financial receivables. However, information was not available that addressed the scope and procedures performed by OTS to determine whether E&Y's work could be relied upon, and the OTS was not critical of E&Y's 1996 workpapers. The workpaper review performed by the OTS and the FDIC examiners in conjunction with the October 2000 visitation helped lead to the discovery of the incorrect accounting treatment for Superior's OC account. The eventual restatement of the OC account was one of the major factors that ultimately led to the closing of this institution.

January 2000 Examination

During the January 2000 examination, a meeting involving the examiners from the OTS, the Federal Deposit Insurance Corporation (FDIC), and E&Y representatives (current and former partners assigned to Superior) provided a more in-depth review of the financial receivables (a/k/a residual interests) area including work performed in completing the E&Y's June 30, 1999, audit of Superior's financial statements. Topics discussed included the institution's escrow methodology, fair value assessments, E&Y's independent modeling, and various other financial receivables related areas. Examiners learned that valuation modeling work was completed by E&Y's Structured Finance Services Group. E&Y's partners advised that E&Y took a global approach in judging this area. An individual fair value calculation of each financial receivable was not performed. Instead E&Y completed a macro analysis to verify reasonableness of the financial receivables net book value and valuation model used by Superior's affiliate,

Fintek.[33] Subsequent to these discussions, the OTS and the FDIC examination teams completed a review of E&Y's workpapers that focused on the extent to which E&Y provided an independent review of the modeling process and fair value recordation.

The examiners workpaper review revealed that E&Y's independent review of the modeling process and fair value recordation process was less than what the examiners anticipated. E&Y performed a limited review and verification of financial receivables fair values as of June 30, 1999, both on an individual and aggregate basis. Following the workpaper review, the examining teams focused their examination work on two primary areas: (1) Superior's recordation of gains and financial receivable analyses and (2) impairment analysis. The teams' in-depth focused examination work revealed that:

- In E&Y's opinion, the balance of the financial receivables appeared reasonable. E&Y indicated that Superior used value assumptions that differed from other securitizers due to its attempt to build-in certain "cushions" to "conservatively" book gains and carrying values. OTS concluded that Superior management's use of a cushion (excess market value over book value) was not supported in Superior's valuation of the financial receivable assets. To derive its own "reasonable outcome" and "conservative" assumptions to be used in E&Y's Structured Finances Services Group's modeling of Superior's gain-on-sale, E&Y used the results of a market survey from recent public offerings (over the period of June 1998 to December 1998). E&Y's work was limited to only one securitization, 1999-1. E&Y concluded that based on this information the value recorded for 1999-1, although on the high end of the range, was reasonable and supportable. At the time of E&Y's audit, Superior had 23 quarterly securitization transactions on its books as of June 30, 1999. Examiners were not comfortable with this minimal coverage given the concentration of financial receivable assets at Superior and the fact that the market survey was 6-12 months old.

- E&Y opined that the 11 percent discount rate used by Superior to value its financial receivable assets was an appropriate estimate based on a survey it conducted of Securities and Exchange Commission (SEC) reports of six publicly held companies that record this type of asset. Superior did not provide adequate support for its use of an 11 percent discount rate in the revaluation of its financial receivables assets. The support provided by Superior was dependent upon the analysis performed by E&Y at the June 1999 audit. E&Y stated that the data it used to determine this rate was from 6 to 12 months old as of June 30, 1999. This data stemmed from the period June 1998 to December 1998, a time when the general level of interest rates was at a historical low. Since the Treasury yield curve on constant maturities of from 2 to 10 years rose between 171 and 180 basis points during 1999, examiners believed the use of the 11 percent discount rate might understate the actual interest rate being used at December 31, 1999 by firms that record this type of asset. Superior attempted

[33] Fintek, Inc., was an affiliate of Superior that managed securitization activities. Fintek modeled cash flows, prepayments, and overall asset-backed structures for Superior.

to provide support for the 11 percent discount rate but failed to do so during the examination.

- E&Y evaluated whether the use of the OC structure as a reserve account impacted fair value given the FAS 125 Q&A Special Report[34] requirement that reserve accounts should be considered as residual interests and that the "cash-out" method (versus "cash-in") is required for determining fair value. E&Y and Superior management contended that the cash-in and cash-out methods produced similar results because in Superior's OC structure (more fully explained under Topic 4 in this report), cash is made available each month as received by the trustee. E&Y contended that in Superior's securitization structure, there was no need to discount the OC assets and no need to model the valuation of the OC account because the asset was pledged to Financial Guaranty Insurance Company (FGIC) and was an owned asset of Superior, and not the trustee. The January 2000 OTS examination report was not critical of E&Y's view of the OC account.

- E&Y's overall conclusion about Superior's impairment analysis was that it appropriately considered and responded to Superior's prepayment experience through the financial receivable asset revaluation process. E&Y reviewed Superior management's impairment measurement (re-runs of a cash flow model from day 1 with revised assumptions) and expressed concern as the methodology deviated somewhat from the approach dictated by GAAP. Notwithstanding, E&Y selected only one securitization series, 1996-4 ARM, for testing the institution's impairment analysis. Overall findings of this review deemed the impairment assumptions to be reasonable for determining the fair value of the 1996-4 ARM. E&Y opined that the balance of the financial receivable assets at June 30, 1999 appeared reasonable. The examiners considered E&Y's review to be superficial.

- E&Y did not perform a documented validation of the model used by Superior's affiliate, Fintek, to value Superior's financial receivable assets. Examiners were concerned with Superior's outstanding exposure levels and current methodologies, and that an affiliated financial consultant company, Fintek, performed the modeling functions off-site. The examiners expected a periodic independent validation to assess model risk would have been part of a sound securitization risk management program.

From June 30, 1997 through June 30, 1999, E&Y went on record with opinions that Superior's financial receivables appeared reasonable. OTS only performed reviews of E&Y's FY 1996 workpapers in 1996 and E&Y's FY 1999 and 2000 workpapers in 2000.

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[34] In December 1998 and July 1999, the Financial Accounting Standards Board (FASB) issued Special Reports, "*A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Second Edition.*" Special Report Question #75 specifically addresses fair value determination of credit enhancement assets.

The January 2000 OTS report of examination was critical of Superior's valuation assumptions. Following the 2000 examination, Superior engaged E&Y on May 12, 2000, to conduct a Special Engagement review of its valuation and impairment measurement methods partly because of the examination results and partly because the bank had revised its methodology in reaction to the issuance of an "Interagency Guidance on Asset Securitization Activities" by the federal banking authorities. E&Y's engagement letter dated May 9, 2000, stated that E&Y was engaged to assist Superior in evaluating the implications and results of altering the bank's current method of establishing assumptions key to the calculation of the present value of financial residuals resulting from the securitization and sale of mortgage loans. The results of this engagement were not available until October 10, 2000, and will follow in chronological order.

In the meantime, on August 22, 2000, the OTS Chicago Regional Accountant placed a telephone call to E&Y's Regional Partner to discuss the accounting for the residual assets (i.e., residual interests and OC account) at Superior. The purpose of the call was to specifically inquire whether Superior was applying the cash-out method correctly and whether the rate paid to the investor was the appropriate discount rate to use for the OC account. It was not clear from the regional accountant's notes that an answer to his inquiry about the cash-out method and discount rate was provided by E&Y's Partner. However, the notes state that the OTS Chicago Regional Accountant suggested to E&Y's Partner that he run his inquiry by his national office (E&Y's Professional Practice Group in its New York National Office) before E&Y issued its June 30, 2000, audit report. The E&Y Partner did not agree or disagree to do this. Instead, E&Y's Partner raised an issue about the composite CAMELS "4" rating issued by OTS after its January 2000 examination and its impact on E&Y's opinion. According to the regional accountant's notes, the E&Y Partner would have to issue a "going concern opinion" because of the composite CAMELS "4" rating and concern that Superior could be taken over by regulators. The OTS Chicago Regional Accountant suggested that E&Y's Partner contact OTS to discuss the rating before the Partner issued a qualified opinion. According to the OTS Chicago Regional Accountant, no meeting was ever held to discuss these issues prior to E&Y's issuance of the June 30, 2000 audit report. E&Y issued an unqualified opinion on Superior's financial statements September 22, 2000.

On September 28, 2000, E&Y issued a memorandum on Financial Receivables in conjunction with E&Y's annual audit. The memorandum followed the issuance of E&Y's Report of Independent Auditors, dated September 22, 2000.[35] According to this memorandum, Superior had adopted and implemented a revised methodology to calculate fair value or the residual cash flows in FY 2000. The purpose of the change in the estimation process was to remove all "cushions" and to adopt a methodology and related valuation assumptions, which were independently verifiable. During its financial receivables review, E&Y analyzed the key features of the revised methodology, most notably, the discount rate, prepayment speeds, and credit losses. E&Y also addressed the "cash-in" versus "cash-out" method of accounting. E&Y's opinion memorandum concluded, "In our opinion, the balance of financial receivables at June 30, 2000 appears

[35] The September 22, 2000 report is E&Y's audit opinion letter with the accompanying financial statements.

reasonable." This opinion reflected the conclusions found throughout the memorandum, as follows:

- Discount rate: The Financial Receivables memorandum concluded that Superior's methodology resulted in a reasonable discount rate and was responsive to the characteristics of the underlying loan pool and applicable environmental factors, if applied in accordance with the methodology. In reaching the conclusions about the discount rate and paragraph 43 of FAS 125, the memorandum states that E&Y's auditors consulted with the firm's Professional Practice Group (meaning its New York National Office) and Structured Finance Services Group.

- Prepayment speeds: Superior developed a methodology to set projected prepayment speeds consistent with the characteristics of the loan pool or sub-pool. Appropriately, the characteristics were evaluated based on the characteristics of the loans remaining in the pool at the time of the valuation in order to recognize that the characteristics of the pool changed over time. E&Y concluded that the methodology was responsive to changes that occur in the make-up of the loan pool throughout the life of the pool. E&Y concurred with the change in Superior's estimation process for establishing a forecasted prepayment speed for the loans in the underlying loans in the pools.

- Credit losses: E&Y found that Superior's data for determining credit losses provided support for anticipated decline in future credit losses as compared to historical results of pools of loans originated in prior years. This data was used to establish forecasted credit loss estimations. Due to the limited loss history for the FY 1999 and FY 2000 pools, E&Y was unable to conclude as to the effect that Superior's data would have upon credit losses. However, based on the magnitude of the effect of the characteristics noted and the shift in the make-up of the pools for FY 1999 and 2000 versus prior year pools, E&Y stated that an anticipated reduction in credit losses of 25 percent would not be unreasonable.

- Cash-in vs. cash-out method of accounting: E&Y offered the same arguments as delineated above during the workpaper review. E&Y contended that the cash-in and cash-out methods produced similar results because in Superior's OC structure, cash was made available each month as it was received by the trustee. E&Y contended that in Superior's structure, there was no need to discount the OC assets and no need to model the valuation of the OC account because the asset was pledged to FGIC and was an owned asset of Superior, and not the trustee.

On October 10, 2000, E&Y conveyed the results of the procedures enumerated in its May 9, 2000 engagement letter. The procedures were established through discussions with Superior's Board of Directors, the Audit Committee, and other advisors. The procedures were performed in conjunction with and in addition to other procedures performed as part of the annual audit of Superior, as of and for the fiscal year ended

June 30, 2000. The nine procedural steps and E&Y's findings and conclusions were enumerated in a report to Superior's Board of Directors. E&Y's procedures are presented below in bold print and are followed by E&Y's findings.

Research and collect information relative to methodologies and disclosures used by other securitizers in the market.

E&Y researched available information contained in public documents, primarily Forms 10K and 10Q as of December 31, 1999 or March 31, 2000, and information prepared and distributed by Morgan Stanley Dean Witter, Prudential Securities, and Merrill Lynch & Co. This research covered over 20 companies. Greater reliance was given to reported information relative to entities that appeared to be operating freely and with a sound financial position. A review of this information provided sufficient evidence to indicate that the unique business risks of each institution was the prime driver of the methodologies used to value financial receivables. Further, the usefulness of the data was limited by the extent of information disclosed by each entity, which also varied. Most useful of the information extracted was information related to the discount rate applied to future cash flows in the valuation process, which is discussed below.

1) **Evaluate pricing of various trust issued debt securities and evaluate correlation to methodologies and disclosures, if any.**

   E&Y wrote that the information listed above (item 1 above) resulted in the conclusion that there is diversity in disclosure information and pricing and, as such, no clear consensus could be reached. The valuation of financial receivables is an estimation process and should vary depending on the risks unique to the issuer.

2) **Research and review data collected by the bank relative to underlying loans both at the time of the underwriting and on an on-going basis.**

   Superior provided E&Y with extensive bank information generated on an on-going basis as well as derived from bank records. A copy of Superior's valuation model was requested and received to test the data provided for four financial receivables (1999-1 fixed, 1999-1 ARM, 1999-3 fixed, and 1993-3 ARM). The model was reviewed for consistency of the functionality with the specific requirements of the related securitization documents. Further, it was reviewed for compliance with industry standards and GAAP. In addition, E&Y reviewed the structural features of the transaction for several other issues. First, the SEC requires the use of the "cash-out" method for valuing the pledged collateral requirement of each pool. Modeling specialists from E&Y's Structured Finance Services Group performed the testing.

   E&Y concluded that the pledged certificates had a distinctively different character than cash flows of residual interest, the repayment of which comes solely from excess interest spreads. E&Y wrote that the pledged certificates were substantially secure as to principle and realized a current floating rate interest payment at a market rate. Further, the cash flow methodology of the model used by the bank was consistent

with this finding and was appropriate. E&Y concluded, that "the Bank's methods are consistent with the "cash-out" method.

3) **Evaluate changes in key assumptions and the inter-relationship to other key assumptions.**

E&Y wrote that the most pronounced behavior influences for loan prepayments related to (1) fixed rate pools versus adjustable rate pools and (2) the variance between the contractual interest rate of the underlying loan and the interest rate currently available to the borrower which directly affected the borrower's decision to exercise the option to prepay the loan and refinance the mortgage. While the above two factors appear to be the most influential, it must be noted that the second, market interest rate levels, is out of the control of the bank, while the first can be controlled.

According to E&Y, the bank's methodology was developed to establish prepayment speed curves and expected future credit loss rates consistent with the characteristics of the mortgage loans within each pool or sub-pool both initially and as the pools age. Appropriately, the characteristics are evaluated based on the characteristics of the loans remaining in the pool at the time of valuation in order to recognize that the characteristics of the pool change through time. E&Y concluded that the methodology utilized by the bank was responsive to changes that occur in the make-up of the loan pool throughout the life of the pool.

4) **Evaluate the Bank's current practice of periodic evaluation of the appropriateness of key assumptions and the rationale for changes, which are adopted.**

To accomplish this review step, E&Y reiterated what was contained in the September 28, 2000 Financial Receivables opinion memorandum regarding the discount rate, prepayment speeds, and credit losses. The conclusions for each of these factors mirrored what was contained in the September 28, 2000 Financial Receivables opinion memorandum.

For the discount rate, E&Y concluded that Superior's methodology resulted in a reasonable discount rate and was responsive to changes in the characteristics of the underlying loan pool and applicable environmental factors, if applied in accordance with the methodology.

For the prepayment speeds, E&Y again concurred with the change in Superior's estimation process for establishing a forecasted prepayment speed for the loans in the underlying loans in the pools. Based on the testing conducted, E&Y was of the opinion that bank personnel were establishing forecasted prepayment speeds based upon objective evaluation of the pool characteristics as of June 30, 2000 and that such assumptions were appropriately based and reasonable.

For the credit losses, E&Y reiterated what was contained in the September 28, 2000, audit opinion letter. E&Y added that as Superior's pools matured, credit loss and other assumptions would be revised to reflect actual results and changes in the characteristics of the loans in the respective pools.

5) **Evaluate the effects of a potential change in the bank's method of accounting, both at the time of sale, and subsequently, relative to the recordation of the residual, the amortization thereof, income recognition and periodic impairment monitoring.**

E&Y noted that Superior chose to record its investment in financial receivables as available for sale. As such, the asset was carried at fair value and any changes in unrealized gains or losses that Superior deemed to be temporary were recognized as a component of equity, net of its tax effect. Impairment, if any, that Superior deemed to be other than temporary was included in current earnings.

E&Y reviewed Superior's accounting policy and related calculations as of June 30, 2000. It was E&Y's opinion that the methodology conformed to GAAP as specified in FAS 125. Further, based on the results of E&Y's testing described in this report, E&Y noted no exceptions to Superior's application of the policy. E&Y noted that quarterly valuation calculations would be made beginning on September 30, 2000. The on-going quarterly revaluation of financial receivable assets would be subject to quarterly testing by both internal and independent third parties.

6) **Review disclosures currently appearing in financial statements and other documents made available to investment bankers.**

E&Y stated that the annual financial statements of Superior had consistently and historically complied with disclosure requirements related to financial receivables in accordance with GAAP. E&Y noted that nothing in the methodology changed or affected the disclosures as previously reported, with two exceptions. First, Superior had previously included in footnotes to the financial statements an item described as "cash flow escrow" variance. With the revised methodology adopted, such variances would no longer be measured as all financial receivables were adjusted to fair value on an individual REMIC[36] level. E&Y reasoned that the cash flow variance no longer had significance to the carrying value and had been removed from the footnote disclosure.

Second, the pledged certificates were reclassified to be included as mortgage-backed assets, which more closely reflected their underlying collateral and characteristics. E&Y agreed with the two changes and was of the opinion that the disclosures as of June 30, 2000 were in conformity with GAAP requirements and had been reflected consistently for all periods presented.

[36] A REMIC is a real estate mortgage investment conduit, which is a multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans. Refer to the glossary for the definition.

7) **Compare and evaluate revised disclosures resulting from proposed changes in methodology, as well as revised disclosures required by recent proposed amendments to FAS 125.**

   E&Y wrote that the proposed amendment to FAS 125, to include enhanced disclosures, would be included in FAS 140 that would replace FAS 125, and would be effective for securitizations occurring after March 31, 2001. As such, the revised disclosure requirements were not yet effective and would not apply to Superior until the issuance of its June 30, 2001 audited financial statements. E&Y noted that while those disclosures were not yet required, compliance with the revised standards would require an expansion of current disclosures. The expanded disclosures would include key assumptions used in the valuation process, particularly related to prepayment assumptions and credit loss assumptions, as well as disclosure of sensitivity to changes in assumptions.

8) **Suggest and perform additional audit procedures to test the effectiveness of any changes in valuation methodology adopted by the Bank.**

   E&Y noted that testing of the effectiveness of Superior's revised methodology was reported upon throughout its report.

As of October 10, 2000, E&Y was still on record in support of Superior's valuation and impairment measurement methodology for financial receivables.

October 2000 Field Visitation

On October 16, 2000, the OTS and the FDIC examination teams reconvened to conduct a field visitation to review Superior's progress in developing a Safety and Soundness Compliance Plan as directed by OTS following the January 2000 exam. The OTS and the FDIC team members reviewed E&Y's June 30, 2000 workpapers including the documentation associated with E&Y's May 2000 special engagement that evaluated the methodology, systems, and controls related to the valuation of the residual interest assets and compliance with applicable accounting standards. Superior's application of FAS 125 in performing the residual interests fair value calculations and its treatment of the OC account were endorsed by its external auditor E&Y, and became one of the visitation's largest concerns.

Again, examiners found E&Y's financial statement audit workpapers and documentation were less than expected in several areas, the most critical involving the OC account and the May 9, 2000, engagement project. Both the OTS and the FDIC were uncomfortable with the calculation of the OC account. The external audit workpaper review and numerous conversations with E&Y representatives and Superior's senior officers did not allay the examiners' concerns. The OTS and the FDIC examiners challenged Superior management and E&Y, advocating that the FAS 125 Q&A Special Report indicated that

when estimating the fair value of a credit enhancement[37] asset, assumptions should include the period of time that the use of the asset is restricted. FAS 125, paragraphs 42 through 44, provided guidance on how to estimate fair value. However, in December 1998 and July 1999, the FASB issued Special Reports in which a question (specifically Question #75) clarified the appropriate method to estimate the fair value of credit enhancements. Under the "cash-out" method, cash flows were to be discounted from the date the credit enhancement asset became available from the securitization trust on an unrestricted basis. In contrast, the "cash-in" method assumes the discount period ends when the cash is expected to come into the securitization trust although credit uncertainties may still remain. The Special Reports stated that a valuation method that does not discount credit enhancement assets for the entire period they are restricted is not an appropriate method to estimate fair value. In Superior's structure, both the financial receivables and OC assets served as credit enhancement assets, therefore, the "cash-out" method for determining fair value appeared appropriate. The regulators contended that in order for Superior to comply with GAAP, the OC account should be carried at fair market value based on the "cash out" methodology outlined in the FAS 125 Special Reports issued in December 1998 and July 1999.

Throughout the October 2000 field visitation, meetings and conference calls among representatives from Superior's management, OTS, FDIC, Superior's holding company, outside consultants, and E&Y were held to attempt to arrive at a solution to the dispute over the accounting treatment afforded to Superior's OC account. The dispute centered on E&Y's contention that present value accounting is not required on the OC assets. E&Y's contention was detailed in its September 28, 2000, Financial Receivables memorandum and E&Y's Partner verbally communicated to examiners that the OC asset did not need to be discounted given that it is earning a market rate of return equivalent to the Class A bond rate.

On November 22, 2000, in a conference call with E&Y's Partner, the Partner once again contended that E&Y's audit work confirmed that although Fintek's cash flow modeling was not similar to the E&Y technical expert's "cash-out" structure, "the end results in terms of gross cash flows and present value are reasonably equivalent. Therefore, Superior's financial receivables are stated at fair value and thus consistent with GAAP."

E&Y's Partner provided summary pages to the OTS and the FDIC participants for the first 61 months of the cash flow waterfall[38] that E&Y utilized for REMIC pool 1999-3 Fixed, which was based on the cash-out method, comparing it to the cash flow waterfall that E&Y estimated the Fintek (Superior's) model would use. The Fintek cash flow was based on the cash-in method. To support his contention, the E&Y Partner presented the following summary information in a table that showed the results of E&Y's modeling of Superior's Series 1999-3 Fixed.

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[37] Overcollateralization is a type of credit enhancement in which the principal amount of collateral used to secure a given transaction exceeds the principal of the securities issued. Credit enhancement occurs when a security's credit quality is raised above that of the sponsor's unsecured debt or that of the underlying asset pool. A type of internal credit support, such as overcollateralization assets, is employed to increase the likelihood that investors will receive the cash flows to which they are entitled.

[38] Waterfall refers to the sequential-pay cash flow allocation payments.

Table 3: Comparison of Superior's Series 1999-3 (Fixed) Financial Receivable and Overcollateralization Actual Carrying Values to Fintek and E&Y Model Valuations

Model	Date	Discount (in 000's)	FR-Net (in 000's)	OC-Net (in 000's)	Total (in 000's)
E&Y "Cash-Out"	9/99	($24,275)	$33,191	$12,744	$45,935
Fintek "Cash-In"	9/99	($24,245)	$45,735	$12,163 [1]	$57,898
Superior Carrying Value	6/00	($20,999)	$39,047	$21,505	$60,552

Source: OTS and FDIC Reports of Examination.
[1] Initial OC deposit booked by Superior at time of sale.

As illustrated, Series 1999-3 Fixed had an estimated value of $45.9 million at the time of sale under E&Y's "cash-out" method. However, as of June 30, 2000, Superior reported a combined financial receivable and OC carrying value of $60.6 million. E&Y's Partner was asked to explain this nearly $15 million increase in the carrying value of Series 1999-3 Fixed over the relatively short 9-month time period. The Partner responded that, all other factors constant, the financial receivable carrying value would increase over time by the discount accretion.[39] The OTS and the FDIC examiners responded that the monthly accretion likely represented no more than $4 or $5 million (as evidenced by the above table). E&Y's Partner had no other reasons for the remaining $10 million carrying value Superior had recorded on its books. It was then evident that E&Y had not reconciled the results of its modeling tests to the actual carrying value on Superior's books. Consequently, the information provided by E&Y's Partner on November 22, 2000 failed to support Superior's fair value modeling and accounting conventions for the financial receivables and OC carrying values.

On November 28, 2000, the OTS Regional Accountant wrote Superior's Chairman of the Board advising him that the telephonic conference call with E&Y's Partner on November 22, 2000, failed to resolve the regulatory concern about the OC asset. The Regional Accountant requested the following information pertaining to Superior REMIC pools 1999-1 Fixed and 1999-3 Fixed as of June 30, 2000 and September 30, 2000:

- The full cash flow waterfalls that were used in the Fintek and E&Y models to derive the value of the financial receivables and OC assets.

- A reconciliation between the E&Y cash-out method model results and Superior's combined net book value of the financial receivables and OC assets for each pool.

On December 19, 2000, the OTS and the FDIC met with Superior executive management, E&Y representatives, and a consultant hired by the holding company, CCFC, to discuss the FAS 125 issue (Special Report Q&A #75 – Second Edition, December 1998 and Special Report Q&A #75 –Third Edition, July 1999.) E&Y's Partner continued to support the accounting position taken in Superior's fiscal year end 2000 audit that the OC assets did not need to be discounted. He contended that Superior

[39] i.e., the securities growth in value over time.

was complying with Q&A #75 since these assets were distinct and segregated property of Superior owned by Superior and pledged to the trustee/FGIC. The OTS and the FDIC representatives strongly disagreed, maintaining that the OC was a credit enhancement asset that should have been discounted in accordance with FAS 125 Q&A #75. The FAS 125 discounting issue remained unresolved at the end of the meeting. OTS agreed to give E&Y's Partner the opportunity to consult with other E&Y personnel and provide the regulators additional support for his position by January 3, 2001.

E&Y Agrees With Regulators

On January 11, 2001, a meeting was held among representatives from Superior's management, OTS, FDIC, Superior's holding company, outside consultants, and E&Y about the discounting issue. A national review official for E&Y acknowledged that E&Y's Engagement Partner was incorrect and the examiners' conclusions were accurate with respect to the appropriate accounting treatment applicable to the financial receivable assets. E&Y ultimately agreed that the regulators' position on the "cash out" method was valid. E&Y's review official from New York acknowledged that intensive study and discussions among E&Y, Superior, and the parent company shareholders had occurred since the December 19, 2000 meeting called by OTS. E&Y's revised position was reported to Superior and the shareholders on January 8, 2001. E&Y believed that recalculations for the initial recordation of the OC account were necessary along with reconstruction of the cash flow models for each securitization since inception. In short, the OC account should have been discounted and the cash flows from the trusts treated under the "cash out" method in accordance with FAS 125. Superior agreed to the need to perform recalculations. Superior's representatives requested additional time to recalculate the accounting value of residual interests on its books and estimated that this work could take as long as 90 days. This revaluation resulted in a mandatory write-down of the overcollateralization account totaling $270 million that was recorded during the first quarter of 2001.

The audit of Superior's June 30, 2001 financial statements was not completed before Superior closed. In addition E&Y was subsequently replaced by Arthur Andersen, LLP, as Superior's external auditor.

In addition, on October 16, 2001, the then Director of OTS testified before the Senate Banking Committee about the incorrect accounting treatment and unrealistic assumptions for valuing Superior's residual interests. "The risk from a concentration in residuals at Superior was exacerbated by a faulty accounting opinion by the institution's external auditors that caused capital to be significantly overstated, and by management and board recalcitrance in acting on regulatory recommendations, directives and orders," the Director said.

Disregard for the Regulatory Process

Superior management failed to implement several examination recommendations subsequent to the January 1999 examination and continued to delay required adjustments

to the financial statements during the course of an OTS field visit. Superior management's reluctance to conform resulted in Superior filing inaccurate TFRs. Management did not write-off 100 percent of an automobile loan category as directed by OTS, did not write-off future advertising credits as directed by OTS, and did not adjust the classification of certain loan assets that Superior reflected as being sold without recourse, but were sold with recourse. The effect of these adjustments on Superior's capital ratios was unfavorable because they would have required Superior to increase capital by $24 million. Superior's TFR showed that it met the risk-based capital (see Topic 5 and Glossary) definition of a "well capitalized" institution by only $1,543 million at June 30, 2000. OTS should have required Superior to file corrected TFRs when material errors were found, and taken enforcement actions against Superior and its management when Superior continued to delay required adjustments to the financial statements. The following table summarizes the adjustments that were not made with the effect of the adjustments at June 30, 2000.

Table 4: Summary of Overstated Capital Because Superior Did Not Make Adjustments Required by OTS

Description	Amount Pretax	Effect
Prepaid Advertising Adj.	$ 3,002,000	Reduce Capital
Note Suits Adj.	8,983,292	Reduce Capital
Recourse Loan Sale Adj.	10,784,000	Additional Capital Requirement
Auto Bankruptcies Adj.*	1,247,000	Reduce Capital
Total Pretax Capital Needed	$24,016,292	

Source: OIG analysis of OTS October 2000 Field Visitation Report

* The CFO did not include the $1.2 million in bankruptcy adjustments for June 30, 2000 because he was unable to separate the accounts to show those that had perfect payment histories for the past 6 months.

The OTS Regulatory Handbook, Section 10, Handbook Use, and Section 70, Overall Conclusions, sums up the regulatory process as an assessment of an institution's degree of safety and soundness and an objective evaluation of its condition by OTS personnel who report their findings, inform the institution's Board of Directors of strengths and weaknesses, and facilitate corrective action where needed. The primary goal of the regulatory process is to ensure that institutions are operated in a safe and sound manner and that the regulatory process prevents problems from developing or escalating in the future; therefore, early identification of risk is necessary.

Also, Section 330 of the OTS Regulatory Handbook entitled, Management Assessment, further delineates management practices and procedures that OTS examiners need to assess in their evaluation of an institution's management. In addition to evaluating the knowledge, skills, and abilities of individual managers, the results of their decisions, and the institution's regulatory compliance and financial performance, examiners must consider the responsiveness to recommendations from auditors and supervisory authorities. Supervisory authorities look to management to implement corrective action in response to directors' requests and regulatory supervision requirements. Management should establish procedures to ensure continuing compliance. Corrective action must be

responsive to the cited criticism and implementation of appropriate action must be timely. Management must explain any noncompliance with supervisory requirements.

According to OTS regulation 12 CFR 560.160, *Asset Classification,* each savings association must evaluate and classify its assets on a regular basis in a manner consistent with, or reconcilable to, the asset classification system used by OTS in its *Thrift Activities Handbook.* In connection with the examination of a savings association or its affiliates, OTS examiners may identify problem assets and classify them, if appropriate. The association must recognize such examiner classifications in its subsequent reports to OTS. Based on the evaluation and classification of its assets, each savings association shall establish adequate valuation allowance or charge-offs, as appropriate, consistent with GAAP and the practices of the federal banking agencies.

Generally, Superior's management officials were responsible for planning, policy-making, personnel administration, maintenance of internal controls, and management of information systems. In addition, a specific Superior key manager, the Chief Financial Officer (CFO), was responsible for classified asset reporting and for providing OTS examiners with requested financial data, budgets, accounting information, and most major operational data requests. The CFO was considered the primary person responsible for verification of the major assets of Superior, including the preparation of Superior's financial statements and TFRs. The CFO also was a signatory on the annual Management Letter examined by E&Y during the annual audit. During OTS examinations prior to the 2000 exam, the CFO was cooperative and quite prompt about supplying requested information to examiners. However, during the 2000 examination and subsequent field visitation, OTS began to question the credibility of the CFO and other Superior management personnel. Specifically, the OTS questioned the handling of directed write-offs and the filing of erroneous TFRs.

Prepaid Advertising

During the course of the 2000 examination, a $12 million difference was noted between the classifications of assets reported at December 31, 1999 and problem assets listed on Superior's Management and Servicing Report for the same date. The examiners' subsequent request for management's explanation of the difference resulted in identifying the sale of $12 million in problem assets. The examiners requested and received a copy of the sales agreement dated December 22, 1999, between Superior and an advertising agency located in New York. The agreement revealed that Superior swapped $5 million in repossessed autos and $7 million in liquidated deficiencies for future credits or discounts on future advertising to be placed with the agency. Superior recorded the transaction by simply debiting Prepaid Advertising ($12 million) and crediting loans ($12 million.) To obtain the credits, Superior would be required to spend $67.3 million within 4 years at prices determined by the advertising agency. Superior management informed OTS examiners that no previous advertising programs had been placed with the advertising agency.

The OTS Regional Accountant determined that the transaction had little or no value and Superior had actually received assets that were inferior to those that were traded. Consequently, the OTS informed Superior that the entire $12 million in future trade credits must be written-off as of December 31, 1999. The value of the credits could not be determined, were contingent upon future Superior spending outlays, and were not marketable as cash equivalents. In addition, the credits were suspect as to the claim of providing extraordinary discounts that would not be similarly offered to other financial institutions proposing large advertising contracts.

Superior's management disagreed with the OTS evaluation of the transaction and stated that the agreement was legal and Superior intended to spend the $67.3 million as part of its future business plans. Superior disagreed that the sales transaction had little or no value and stated that the future credits had substantial value. As of September 30, 2000, Superior only wrote off $9.6 million of the $12 million. The CFO tried to reason that it was appropriate because regulatory policies allowed a write down to collateral value, less selling costs. Because Superior did not make the adjustment required by OTS, Superior's risk-based capital was overstated by $3 million.

Note Suits

Another example of management's disregard for the regulatory process was the handling of another OTS directed write-down of a loan category called "note suits" where Superior was attempting to repossess automobiles, but borrowers had hidden or transported the autos to unknown locations. During the January 24, 2000 examination, Superior was directed in writing and verbally to write-off 100 percent of the note suits category. Superior management agreed to write-off $10.2 million (the original balance of the note suits at December 31, 1999, that OTS later reduced to $8.98 million) in accordance with the Uniform Credit Classification and account Management Policy, a policy adopted by the OTS and other banking agencies. The Uniform Retail Credit Classification and Account Management Policy establishes standards for the classification and treatment of retail credit in financial institutions. According to the policy, closed-end retail loans that become past due 120 days from the contractual due date should be classified a loss and charged-off. The decision to write-off the account was made after extensive discussions with OTS personnel on the Uniform Retail Credit Classification and Account Management Policy. Written instructions to Superior's management to write-off note suits were presented at the examination exit meeting, and the requirement was specifically addressed in the examination report, which was submitted to all directors.

Subsequent to the January 2000 examination exit meeting, a Superior management official responded on behalf of the Board of Directors, that all necessary adjustments were reflected as of March 31, 2000. However, during the OTS October 2000 field visit, OTS examiners discovered that the response was not correct. Superior management did not write-off 100 percent of the note suits as required. Without seeking feedback from the OTS, management renamed and subdivided note suits into two new categories—"Third Party Collections-Out for Repossession" under the substandard category and "Third Party Collections-Other" under the loss category. The CFO explained that management took

the position that if the servicing department determined that the repossession of an auto became more likely with a severely delinquent account, the account could be moved to the 90-day category, regardless of the actual delinquency status. This practice avoided placing these accounts into the 120-day category and thus classifying them as losses to be charged-off. OTS explained to the CFO why this practice was illogical. OTS reasoned that delinquency histories could not be changed based upon a servicing department's claim that the auto now has a better chance of being repossessed. No one from Superior's management informed the OTS of their actions at any time between the examination date and the date of the OTS October 2000 field visit, even though they had several months to do so. Their actions were discovered during the October 2000 field visit through the examiners' review of source documents on classified assets. The CFO said that he was not "playing games" when questioned as to why management changed the severe delinquency status without any actual change to the delinquency status by the borrower. He added that Superior management believed they were following the Interagency Guidelines in classifying assets.

The October 2000 field visitation scope included a review of Superior's external auditor's (E&Y's) workpapers for Superior's fiscal year ended June 30, 2000. During the course of the review, which was held early in the field visit, discussions were held with the Manager of E&Y's Superior audit in addition to E&Y's Partner. When both the Manager and Partner were questioned by OTS whether they had read the January 2000 OTS report of examination, they both responded that they did not see OTS's report of examination. OTS informed E&Y's Partner that OTS did not consider the audited financial statements as of June 30, 2000 to be accurate, because Superior did not record the adjustments to note suits or prepaid advertising (discussed above) as required by the previous examination. The Partner responded that E&Y must not have considered the issues to be material. When again questioned why auditors would not read a regulatory report on a subprime lending institution with an overall rating of "4," E&Y's Regional Partner replied that it just "slipped through the cracks." At a later date, he amended his reply and added that he remembered reading the OTS report in New York City in the presence of Superior's Chairman of the Board. He said that he was not allowed to make copies of the report. In response to OTS inquiries on why E&Y was not allowed to receive a copy of the OTS examination report, E&Y's Partner responded that this was not unusual and other clients also had similar policies. He went on to say that E&Y probably did not consider the issues material.

OTS's review of E&Y's workpapers for the fiscal year ended June 30, 2000 revealed the possibility that Superior had initially submitted a different classified asset schedule to the OTS examiners compared to schedules submitted to E&Y. E&Y's workpapers still showed the note suits category at June 30, 2000 and E&Y's workpapers defined the note suits category, discussed the note suits balances, and noted that approximately one-third of the note suits were written-off "per the OTS examination." OTS concluded that E&Y believed that the note suits still existed as E&Y showed a sizeable balance of $12.4 million at June 30, 2000. E&Y's workpapers did not show the new categories of Third Party Collections-Other and Third Party Collections-Out for Repossession. The initial schedules given to the examiners for the same date did not show the note suits

category, but showed the newly renamed Third Party Collections-Other and Third Party Collections-Out for Repossession. Because Superior did not make the adjustment required by OTS, Superior's risk-based capital was overstated by $8.9 million.

Recourse Loan Sale

The CFO did not adjust the classification of certain loan assets that Superior reflected as being sold without recourse but were actually sold with recourse. Superior sold $207 million in auto loans into a trust as of May 31, 1999. Management stated that the likelihood of recourse to Superior through this sale was remote. However, examiners determined that in fact, Superior had retained recourse for losses from the trust and the bondholders had no exposure to losses. The OTS report of examination recommended to Superior's Board of Directors that the board should ensure that management had reflected all necessary adjustments and reporting requirements to earnings and capital as of March 31, 2000. The report of examination also recommended that the board ensure that management classified all balance sheet assets and off-balance sheet recourse obligations in accordance with the Uniform Retail Credit Classification Policy. (Refer to Topic 5 for a detailed discussion of this policy and its impact on Superior.)

The January 2000 examination report clearly detailed the OTS's conclusion as to whether recourse existed from a $207 million auto loan sale that occurred during 1999. Management had previously determined that recourse did not exist and informed the OTS of this conclusion in at least one meeting held prior to the January 24, 2000 examination date. However, the examiners later determined after a review of the legal documents that, contrary to management's claim, the sale did include a recourse provision whereby Superior accepted recourse for losses through the structure of the transaction. The probability of losses being incurred by Superior was remote, but the examiners and the Regional Accountant determined that recourse did exist. Consequently, Superior's management was verbally informed during the January 2000 examination of this conclusion. A written memo was given to management during the examination that explained the rationale for the OTS decision. The memo was again presented at the exit meeting near the end of the examination. The subject was also clearly explained in the examination report. In all instances, Superior was instructed to convert the underlying loans to on-balance sheet assets at the 100 percent risk-weighted category in the risk-weighted asset calculation on the TFR. The Board of Directors' reply to the examination report stated, "Management has taken steps to reflect all necessary adjustments and reporting as of March 31, 2000 in accordance with the comments included in the Report of Examination."
The OTS October 2000 field visit disclosed that management did not implement the instructions as required. Instead, management significantly reduced the capital effect of OTS's instructions by reporting a "low level recourse" situation, even though the low level recourse was not applicable. Management never informed the OTS that it had made this decision and at no time during the previous examination did management ever discuss low level recourse as an option. Similar to note suits and the prepaid advertising examples, the examiners found management's unilateral decision through a review of the capital calculations in the TFR. Management considered the low level recourse

calculation as appropriate and did not have a response to OTS's question of why Superior never informed the OTS that it was considering other interpretations of OTS's original detailed instructions. Because Superior did not make the adjustment required by OTS, Superior needed to increase risk-based capital by $10.8 million.

Thrift Financial Report Errors

Management displayed disregard for the regulatory process by filing erroneous TFRs from 1998 through 2000. TFRs in 1998, 1999, and 2000 contained material errors that overstated Superior's capital position. In its 1997 examination report, OTS found delinquent auto loans and repossessions had not been included in classification totals in regulatory reports (TFRs) during 1997. The classification totals were shown on Schedule VA—Consolidated Valuation Allowances and Related Data, of the TFR. Specifically lines VA960, VA965, VA970, and VA975 showed End of Quarter Balances for Special Mention,[40] Substandard,[41] Doubtful,[42] and Loss[43] classifications, respectively. As reported, classified assets were below the levels reported by other institutions like Superior—its peers—as of September 30, 1997.

Superior did not include all appropriate classified assets, including delinquent auto loans and repossessions and real estate owned, in TFR reports to OTS during 1997. If these assets had been included as of September 30, 1997, it would have resulted in a doubling of classified assets and a revision of Superior's classified asset status from below peer level to above peer level. Notwithstanding, OTS examiners concluded in 1997 that the higher classification levels were still not a concern due to the extremely high earnings and acceptable capital level of Superior. There were no matters reported that required a response from the Board of Directors. Management provided assurance that the classified asset totals in future regulatory reports would include all appropriate assets.

According to the OTS Regulatory Handbook, Section 410, Financial Records and Reports, the accuracy of the TFRs is extremely important, because information contained in the reports is used to monitor savings associations between examinations. If inaccurate

[40] On June 10, 1993, the federal banking and thrift regulatory agencies issued uniform guidance to clarify the use of Special Mention for supervisory purposes. The four agencies adopted the following uniform definition for Special Mention assets: The Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

[41] An asset classified Substandard is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any.

[42] An asset classified Doubtful has the weaknesses of those classified Substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

[43] That portion of an asset classified Loss is considered uncollectible and of such little value that its continuance as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer writing off a basically worthless asset even though partial recovery may be effected in the future.

data are submitted, changing patterns of behavior or deteriorating trends may not be detected in an individual savings association. If compounded, a distorted picture of the industry condition can result. The OTS must have reliable data so it can assess and monitor a savings association's financial condition and activities. The regulator should ascertain whether any reports are presented to the Board of Directors in addition to the required reports such as the TFR. The content of any additional reports should also be reviewed for accuracy and adequacy. Regulators should also determine whether the submission of inaccurate or inadequate reports is the result of an intentional act on the part of management. The regulator should follow up on all items deemed worthy of further investigation and obtain a satisfactory response from management, explaining specific questionable matters.

Although OTS was not concerned after its 1997 examination, OTS changed its position during the 1999 examination when OTS examiners found that classified asset levels remained lower than reported to OTS for all quarterly periods in 1998. Notwithstanding management's assurances following the 1997 examination, classification errors were not detected within Superior's review process. The institution's classification policy required the CFO to prepare quarterly classified asset reports for review by Superior's Board of Directors. The CFO's quarterly classified asset report included delinquency and repossession reports from all four of Superior's divisions. However, OTS examiners found no individual report existed to summarize the final conclusion for Superior's classified assets except the TFR. Examiners concluded that the TFR data was insufficient for the Board of Directors to properly analyze the 19 categories of classified assets from Superior's four divisions that comprised classified asset totals at December 31, 1998. The CFO initially disagreed with the examiners' final classification totals, but subsequently agreed to include the revised asset categories in future reports. The CFO later agreed to prepare a summarized asset classification report for the Board of Directors on a quarterly basis.

OTS conducted a field visitation in September 1999 to review corrective action on the findings of deficiencies in management reporting of classified assets at the safety and soundness examination dated January 25, 1999 and the apparent continued reporting deficiencies in two TFRs. The OTS field visitation report indicated that management improved Superior's classification reporting system and internal reports because the reports now included all known balance sheet assets for classification consideration. However, Superior management's analysis of the problem assets was unacceptable and resulted in the continued understatement of classified assets on Superior's TFRs as of March 31 and June 30, 1999. The understatements were attributed to the auto loan division. Consequently, OTS gave detailed written instructions to management for each category of problem auto receivables.

Management erroneously designated a substantial portion of its impaired auto loan receivables as special mention and also incorrectly calculated expected loss amounts on certain auto receivable categories that resulted in a less severe classification for the remaining balance. This resulted in classifications being underreported by approximately 50 percent on the June 1999 TFR. The June 1999 TFR showed $40.8 million in

classified assets; however, OTS examiners tallied amended totals of $61.1 million in classified assets for criticized assets as of June 30, 1999. Management also underreported, on the TFR, the total allowances for the auto division for the first two quarters of 1999. The underreported amounts on the TFRs were $19.5 million for March 1999 and $26.8 million for June 1999. Again, management promised to follow the instructions and revise the TFRs as well as increase the classified asset categories for June 30, 1999.

During the January 2000 examination, the OTS and the FDIC examiners focused on Superior's valuations of residual interests and the classification of problem assets identified in the previous examinations. At previous examinations, Superior was found to be underreporting the level of classified assets on its TFRs, but the 2000 examination found that management had included all the loans on the institution's balance sheet for classification consideration. However, examiners determined that the previously reported ALLL was incorrect. The examination found that Superior incorrectly reported the ALLL on the December 31, 1999 TFR. Superior reported $128.5 million in the ALLL; however, the examiners concluded that only $2.6 million was eligible for inclusion in the ALLL as of December 31, 1999. The previously reported ALLLs were largely determined by examiners to be incorrect and the excess market value over book value of the financial receivables was erroneously designated as part of the ALLL. Table 5 summarizes the reasons for the significant restatement and shows the actual verified ALLL.

Table 5: Summary of the ALLL

Description	Balance (000's Omitted)
Reported ALLL at December 31, 1999	$128,519
Less TFR Reporting Error	(2,922)
Less Reclassification of Allowances	(76,884)
Subtotal	$ 48,713
Less "Unverifiable Cushion"	(46,115)
Actual Verified ALLL	$ 2,598

Source: OTS January 2000 Report of Examination.

The OTS January 2000 report of examination attributed $2.9 million to TFR reporting errors but did not explain how OTS identified the errors. As for the $76.8 million, the report of examination explained that the initial adjustment to the ALLL was required by a new understanding of the financial receivables book balances compared to management's valuation of the receivables. Superior's general ledger as of December 31, 1999 showed a gross book balance of $663.4 million for financial receivables. However, management submitted a valuation of the financial receivables during the examination totaling $586.6 million for the same date. The initial difference of $76.8 million between the gross book balance and management's valuation represented a loss or write-down that removed this respective amount from the ALLL category. The remaining $46.1 million "cushion" that management categorized as an ALLL was technically an unrealized gain

and not an allowance. During the examination, management was requested to find support for this amount but was unable to support the claimed "cushion" or unrealized gain of $46.1 million. Table 6 shows the amounts of the verified ALLL categorized by Superior's operating divisions.

Table 6: Summary of Verified ALLL by Superior Operating Division

Adjusted ALLL	Balance (000's omitted)
Superior Direct	$ 3
Universal	9
Alliance Funding	345
Retail	827
Auto Division	1,414
Total Revised ALLL	$2,598

Source: OTS January 2000 Report of Examination.

In addition, the OTS and the FDIC examiners found numerous errors on Superior's September and December 1999 TFRs that also distorted Superior's financial condition. A prime example cited in the January 2000 OTS examination report was financial receivables totaling $672.4 million that were overstated on the TFR Schedule SC-Consolidated Statement of Condition —Mortgage Derivative Securities, SC line 150, $666.6 million and Other Investment Securities, SC line 185, $5.6 million. According to the Thrift Financial Report Instruction Manual, these assets should have been reported as IO Strip Receivables and Certain Other Instruments on SC line 655. According to the TFR instructions for SC line 655, Superior should have reported the amortized cost of the portion of interest-only strip receivables, loan receivables, other receivables, or residual interests in securitizations. These assets had to be amortized because they could be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

After the January 2000 examination, Superior's board was given a list of items for management to address. Among them were necessary adjustments and reporting requirements to earnings and capital as of March 31, 2000. Also, the board was to ensure that management took actions to support the valuations of the residual interests, to determine a sufficient ALLL, and other actions. One of the other action items involved measures that were needed to prevent information delays caused by the CFO during the 2000 examination. Requests for documentation that were forwarded to Superior prior to the commencement of the examination and follow up requests were not answered in a timely manner. The CFO was primarily responsible for providing the requested information.

In October 2000, the OTS and the FDIC teams reconvened to conduct a field visitation to review Superior's progress in developing a Safety and Soundness Compliance Plan (a Corrective Plan delineated in 12 CFR Part 570) and other issues identified during the previous examination. In general, they found that Superior's management continued to operate outside of a disciplined framework expected of an insured depository institution.

The OTS field visitation report concluded that Superior's financial statements were not fairly stated as of June 30, 2000. The reported financial statements had apparent misstatements on asset valuations, which would result in a corresponding significant adverse impact on Superior's capital position. The OTS and the FDIC examiners concluded that the residual interests and the OC account were substantially overstated as of June 30, 2000, and also as of September 30, 2000. The examiners estimated that the inflation of the financial receivables and OC assets ranged from a minimum of $200 million to as much as $300 million as of June 30, 2000. Subsequent to the October visitation, meetings among the OTS, the FDIC, E&Y, and holding company personnel were held to come to some type of an agreement on the issue. At a meeting held on January 11, 2001, a national review official from E&Y acknowledged that Superior's and E&Y's position on the accounting treatment for the OC account was incorrect. The OTS and the FDIC's position were the correct interpretation of Statement of Financial Accounting Standard (FAS) 125. In March 2001, the OTS and the FDIC conducted what would be their last examination of Superior.

In addition to Superior's incorrect interpretation of FAS 125, Superior's financial statements and TFRs at June 30, September 30, and December 31, 2000 also contained other significant errors. The CFO filed all of these TFRs and was ultimately responsible for the accurate and timely filing of TFRs. Superior's Board of Directors removed the CFO in early January 2001.

OTS advised Superior by letter, dated May 3, 2001, of substantial questions about the accuracy of Superior's March 31, 2001 TFR. Several representations by management concerning the calculation of the financial receivables and OC assets, during a critical phase of OTS's 2000 examination, were later determined to be incorrect. According to an OTS memorandum, OTS believed the CFO, who was removed in early January 2001, made false and misleading statements to examiners, in violation of 12 CFR §563.180(b)(1). The October 2000 field visit was considerably lengthened by management's failure to provide requested documentation in a timely manner, and by the submission of incomplete documents. OTS should have required Superior to file corrected TFRs when material errors were found and taken enforcement actions against Superior and its management when Superior continued to file erroneous TFRs.

Topic 4 - Regulatory oversight of the institution's high-risk lending activities including the underwriting and accounting practices used by the bank for origination and securitization of subprime[44] loans.

With the exception of 1998, the Office of Thrift Supervision (OTS) conducted annual safety and soundness examinations of Superior from 1991 until its closure. OTS' emphasis centered on the securitization process, which was the mainstay of the institution. The OTS also conducted reviews of the underwriting of the loans, which served as the collateral for the securitizations. Additionally, beginning with the 1996 examination, the OTS used capital markets specialists to conduct extensive reviews of the securitization process. The Federal Deposit Insurance Corporation (FDIC) participated in the 2000 examination and visitation and the 2001 examination. The FDIC also included capital market specialists on its staff. The accounting practices that Superior used were reviewed. At the January 2000 examination, both agencies questioned the assumptions that Superior used to value the residual interests. During the October 2000 visitation, it was determined that the accounting practices were not interpreted correctly and the OC account and the residual interests were overstated. Subsequent write-downs at the March 2001 examination further reduced Superior's capital.

The Review of Residual Interests

The Office of Thrift Supervision (OTS) maintained an annual examination presence in Superior from 1991 until its closure.[45] Superior's management commenced its securitization business in March 1993 following the incorporation of Alliance Funding Company, Inc. (Alliance) as a division of Superior in December 1992. As part of the examination process, the OTS reviewed the activities related to the securitization process. The OTS's major concern was the increasing volume of residual assets[46] on Superior's financial records. The 1994 examination included a recommendation that the board

[44] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

[45] An examination of Superior was not conducted in 1998.

[46] The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

establish limitations on the volume of residual assets as a percentage of capital that the institution would permit. The Board of Directors did not implement the recommendations and continued to expand Superior's holdings of residual assets. Beginning in 1995, the OTS still had concerns; however, the OTS reports stated that Superior's capital levels mitigated their concerns regarding the high level of concentrations. The residual assets were listed as a concentration; however, the OTS did not take any further action regarding this mounting level of high-risk assets until the OTS issued issued the Part 570 Directive in July 2000.

The OTS examinations from 1993 through 1995 identified shortcomings in Superior's financial reporting. The residual assets were incorrectly categorized on the Thrift Financial Reports (TFR). The first reported instance of incorrect reporting occurred in 1993. A reminder was given to the board and management on where to correctly include the totals on the TFR. The same errors occurred on the 1994 TFR. The OTS continued to remind the board throughout this period about the need to accurately report values on the TFRs; however, no corrective action was taken. The 1996 examination report did not indicate whether or not the reporting errors were corrected. Superior continued to file inaccurate TFRs, as reported in the 1997, 1999, 2000, and 2001 examination reports.

Superior began extending and securitizing subprime automobile loans in 1994. In addition to the other focal points, the OTS reviewed the automobile lending area and its securitization activities. One of the criticisms in the examination reports from 1997 until 1999 pertaining to this area included the omission of delinquent auto loans and repossessions from the balances of classified assets reported in the TFRs.

In 1996, the OTS conducted an intensified examination of the securitization process at Superior. OTS Washington elicited the assistance of an examiner from the OTS's Southeast Region to provide expertise in the securitization area on this examination. After reviewing the documentation, he determined that the valuations were reasonable and no criticisms were levied in this area. Similar results were obtained from the 1997 and 1999 examinations.

Because of Superior's size, the Federal Deposit Insurance Corporation's (FDIC) off-site monitoring was required through the former Billion Dollar Insured Depository Institution[47] program. In October 1998, an FDIC case manager was reviewing Superior's TFR and E&Y's audit report that were submitted as required by 12 CFR Part 363. He noted the inordinate size of the residual assets and the ALLL in relation to other financial institutions. The case manager contacted the OTS field manager to inquire about participating in the upcoming OTS examination in order to alleviate the FDIC's concerns. According to protocol, the FDIC prepared a letter to the OTS requesting permission to join the examination. The OTS regional director stated that he never saw the letter. The FDIC did not gain access to the institution; however, FDIC personnel were allowed to present questions to the OTS examiners which were discussed between the two agency representatives during the last week of the examination. (Refer to Topic 9 for a detailed discussion of the FDIC's efforts to participate in the 1999 OTS examination.) After

[47] Refer to the Glossary for an explanation of the Billion Dollar Insured Depository Institution program.

reviewing the OTS's Report of Examination. the FDIC downgraded the rating from the composite "2" assigned by the OTS to a composite "3" for risk related insurance premium purposes.

The 2000 Examination

Three FDIC examiners joined the OTS at the 2000 examination of Superior. At the conclusion of the examination, the institution was rated a composite "4" by both regulators. Following the January 25, 1999 examination, Superior's management changed its assumptions for valuing the residual interests, thereby inflating their values. The level of residual assets was growing at an excessive rate. The total of adversely classified assets had increased, primarily from the automobile division, and write-downs were required to reflect accurate values for the assets. The Allowance for Loan and Lease Losses (ALLL) was overstated due to the inclusion of valuation reserves for the residual interests that should not have been included in the ALLL. Following examination adjustments, the total in the ALLL declined from $128 million to $2.6 million.

The OTS calculated the capital ratios at the conclusion of the examination to determine Superior's Prompt Corrective Action (PCA) category. Loss classifications were calculated on a pre- and post-tax basis prior to calculating the capital ratios. Because OTS used the post-tax capital calculation of 8.57 percent versus the pre-tax value of 7.81 percent, Superior was considered adequately capitalized instead of undercapitalized for PCA purposes. During interviews with OTS examiners and executive personnel, we asked if this practice of calculating examination losses on a pre-and post-tax basis was customary. According to the OTS Regional Director in Chicago, this practice is used at the discretion of examiners to reflect a more accurate picture of the institution's capital position. An effective[48] tax rate of 39 percent was used to perform the calculation. In contrast, the OTS's Chief Accountant stated that an effective tax rate could not be used on an institution that has a complicated income tax structure and return. By calculating the ratios on a post-tax basis, OTS classified Superior as an adequately capitalized institution following the January 24, 2000 examination instead of an undercapitalized one. This practice was also used by OTS to determine Superior's PCA category as of December 31, 2000. Because of the effects of post-tax losses and the exclusion of the $150 million write-down associated with the residual interests[49], Superior was classified for PCA purposes as significantly undercapitalized during the March 2001 examination. If these adjustments were made, it is probable that Superior would have been critically undercapitalized. Refer to Table 8 for a detailed listing of specific capital ratios.

An area of uncertainty arose during the January 2000 examination. The examiners questioned the unsupported assumptions used to value the residual interests. The

[48] The effective tax rate is the amount of tax divided by the taxable income.

[49] The write-down of the residual interests was deferred because of negotiations between the OTS and Superior's owners to devise a recapitalization plan. We do not understand why this would justify any delay in writing down the assets, but it had the effect of inaccurately presenting the institution's financial condition. The write-down was incorporated in July 2001 when the owners failed to implement the recapitalization plan.

examination review indicated an initial impairment of $1.2 million on certain mortgage pools. The OTS recommended that Superior implement procedures to determine the fair value of the residual interests and adjust the book values accordingly. Both regulators downgraded Superior to a composite rating of "4" following the 2000 examination. In July 2000, the FDIC again downgraded Superior for risk related insurance premium purposes because of the results of the 2000 examination. In July 2000, the OTS issued a Part 570 Directive to address the deficiencies noted at the January 2000 examination.

The October 2000 Visitation

During the October 2000 visitation, the agencies determined that Superior and E&Y were not applying Statement of Financial Accounting Standards (FAS) 125 correctly to the valuation of the OC account. It appeared that the incorrect valuation process had been in place since the inception of the account in 1995. Discussions with the accountants and Superior personnel ensued and in January 2001, the issue was resolved. The national partner from New York reviewed E&Y's work and determined that the regulatory agencies were correct in their interpretation of FAS 125.

The 2001 Examination

The FDIC participated with the OTS in the March 2001 examination. Write-downs associated with the OC account to bring the valuation into conformance with FAS 125 negatively affected Superior's capital position. Superior was now considered significantly undercapitalized for PCA purposes. Additionally, because Superior was unable to produce adequate documentation to support its valuation assumptions, further write-downs were expected for the residual interests. According to the 2001draft FDIC examination report, if all examination losses were deducted from capital, Superior would have been insolvent. The OTS issued a PCA Directive to Superior on February 14, 2001, which placed restrictions on the distribution of capital, asset growth, compensation paid, and restrictions on acquisitions, branching, and new lines of business. Superior was also required to file a capital plan. Specific requirements pertaining to the establishment of an escrow account and the sale of loans were also included in the directive. The OTS issued Cease and Desist Orders to Superior's first and second tier holding companies, Superior Holdings, Inc. and Coast-to-Coast Financial Corporation on February 14, 2001. The Order required the holding companies to establish an account at Superior with a specified dollar amount to absorb any losses Superior incurred on loan sales. Neither holding company was permitted to declare or approve any capital distributions; renew or incur any debt without the written approval of the Regional Director; pledge or encumber any assets of the holding companies or Superior; or maintain, renew, or modify existing warehouse lines of credit to finance the purchase loans from Superior. Also, the holding companies were directed to follow Generally Accepted Accounting Principles.

The OTS and Superior's owners began negotiating a recapitalization plan as required under PCA. Superior submitted a Capital Plan on time; however, the OTS did not consider it acceptable. Three amendments and two revisions later, the OTS accepted the Capital Plan. The owners were required to implement the plan no later than

July 23, 2001. However, after lengthy negotiations, the owners decided not to implement the plan. The OTS declared Superior insolvent and closed the institution on July 27, 2001.

Underwriting

Prior to becoming an affiliate and later a division of Superior, Alliance's main line of business was originating, purchasing, and securitizing non-conforming mortgage loans. Alliance used a network of 968 brokers located throughout the United States from whom they purchased loans. According to OTS personnel and examination reports, the level of loans that were obtained from these indirect sources ranged from approximately 70 to 80 percent of the loans that were securitized, with only 20-30 percent generated from within the organization. Since brokers typically generate their compensation based on the volume of loans that are accepted by the institution, they are more inclined to use aggressive techniques to solicit borrowers. Also, in a declining interest rate environment, brokers may attempt to entice the more creditworthy borrowers to refinance their loans, which can increase the prepayment risk to institutions that have packaged these loans in securitizations.

In 1999, Superior originated 31,744 one-to-four family mortgage loans totaling $2.2 billion. These loans were categorized into three income verification categories including full income verification, partial income verification, and non-income verification. These three categories were further divided into 13 categories based on the underwriting standards that ranged from "A" type borrowers to "C" type borrowers. This group also included a few "D" type borrowers. Generally those borrowers that fell into the lower credit quality group must have more equity in their residences compared to the higher credit quality borrowers. Superior obtained credit scores; however, they were seldom used since each loan was underwritten on an individual basis. According to the OTS and FDIC examiners and DRR personnel that reviewed the loans supporting the securitizations, the loans extended in the earlier issues were better quality. In contrast, the loans in the later issue had high delinquency rates and large losses indicating the liberalization of lending standards in order to generate a higher volume of loans.

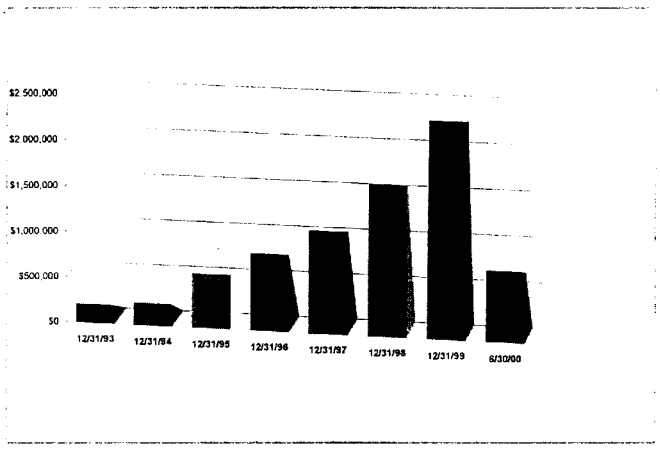
Other influences noted by OTS personnel, which may have contributed to Superior's lowering the credit quality standards, included the following:

- Competition in the subprime market was increasing and becoming more aggressive,
- Superior wanted to increase the volume of securitizations (that is, by lowering the credit standards, there was a larger population of subprime candidates to include), and
- Superior directed its advertising campaigns to lower quality borrowers who may have elected to take advantage of the loans.

Loan to value ratios on the mortgage loans were reported to be in the high 70 to the low 80 percent range. However, OTS personnel indicated that second mortgages were

included in some of the securitizations and therefore the loan to value ratios could be much higher.[50] Figure 1 illustrates the volume of loans that Superior securitized from 1993 until June 2000.

Figure 1: Volume of Loans Securitized Annually by Superior (000s omitted)



Source: Ernst & Young Audit Reports (6/30/93 – 6/30/00 *)
* The years 1993 – 1999 include the entire year. The 2000 value only include the first 6 months of the year. Superior ceased securitizing loans as of June 30, 2000.

At first, Superior did not use FICO[51] scores to assist in the assessment of the repayment ability of borrowers. Instead, Superior relied on internal classifications of borrowers based on the number of delinquencies, defaults, bankruptcies, or other similar characteristics. Later, when Superior incorporated FICO scores, the scores indicated a declining trend. OTS examiners stated that in 1999, the underwriting standards deteriorated in order to generate a greater volume of loans. Reportedly, Superior made efforts to tighten the lax standards in 1999; however, the increase in loan losses does not indicate that Superior was successful with this effort.

[50] A second mortgage is a mortgage that is subordinate to the lien created by a first mortgage. It is in effect, an installment loan secured by the borrower's real estate with a predetermined repayment table. Second mortgages are used for a variety of reasons including home improvement, investment in a business, and raising cash. If real estate has a first mortgage, the loan to value ratio is the amount owed divided by the value of the real estate. If the real estate has a first and second mortgage, the loan to value ratio increases due to the amount of the outstanding debt.

[51] FICO is the Fair Isaac Company credit scoring. Credit scoring predicts the creditworthiness of credit applicants using a statistical model. Credit scoring estimates the repayment probability based on the information in the credit application and a credit bureau report.

OTS Placed Too Much Reliance on Superior's Management

As described earlier, two wealthy family groups purchased Superior Bank in 1988 through their holding company, Coast-to-Coast Financial Corporation (CCFC). They later incorporated additional entities under the CCFC umbrella, including a mortgage banking entity, which later became a division of Superior, and Fintek, Inc. (Fintek), a former capital markets group from another institution owned by one of the principals of CCFC. Fintek provided investment assistance to Superior and also performed the modeling to determine the market values for Superior's residual interests. The President of Fintek was a director of Superior and later became Superior's Chairman of the Board (Chairman). The Chairman had been involved with Superior since 1990. The Chairman's skills coupled with the retail banking experience of the Chief Executive Officer (CEO) and President, who was retained in 1993 for his retail banking expertise, prepared Superior to embark on its new business strategy of subprime securitizations. The following table indicates the compensation received by some of the highest-ranking officers at Superior.

Table 7: Superior Bank - Executive Officers' Compensation

Position *	1999	2000	2001
President	$431,400	$436,400	$299,359
Executive Vice President	$834,000	$784,000	$886,421
Senior Vice President	$475,000	$505,000	$364,499
Senior Vice President	$305,550	$308,050	$136,200

Source: OTS Examination Reports

* Total compensation includes salary, bonuses, awards, deferred compensation, executive performance program, director fees, auto allowances, country club dues, special awards, and relocation payments. The 2001 income includes compensation as reflected in the OTS's March 19, 2001 Report of Examination.

From the onset, the OTS considered the new management team and the Board of Directors to be capable managers, involved in the affairs of the institution and well informed. From discussions with OTS personnel, they believed that this group of individuals had the ability to manage and administer Superior's business activities. Also, because of their financial status, the OTS placed a great deal of reliance on the ability of the owners to inject capital if the institution encountered any financial difficulties. The owners were also averse to publicity, especially publicity that would sully their reputation. They were community oriented and saw the subprime lending area as a way to advance relations in their community. There were many individuals in Superior's immediate community who could be classified as subprime borrowers. Without the offering of these loans by Superior, they might be unable to obtain financing. Additionally, because of their wealth and stature in the community, the owners would be able to lend support to Superior as well as recruit competent individuals to administer the affairs of the bank.

The consensus of opinion among OTS personnel was that the owners and management were a group of reputable people. When the examiners criticized areas of the institution,

management was quick to respond with promises to take action. Even when the promises proved empty, the OTS still had faith and confidence in their ability. Even after the 2000 examination when the OTS examiners downgraded the institution to a composite "4," OTS personnel still believed that management would be able to resolve the problems.

In the first quarter of 2001, the OTS designated Superior as significantly undercapitalized as of December 31, 2000 due to examination adjustments. Management filed the March 31, 2001 TFR and included three qualifying statements relating to the reported value of the residual interests, the capital contribution from CCFC, and the right of offset. (Refer to Topic 2 for a detailed discussion of the TFR adjustments.) The OTS objected to all three statements; however, the OTS did not require Superior to amend its TFR. This decision was due, in part, to the ongoing negotiations for the recapitalization plan and the OTS's belief that the owners would make the institution whole.

Favorable Capital Ratio Calculations Enable Superior to Remain Above an Undercapitalized Category for PCA Purposes

At the conclusion of the 2000 examination of Superior and during the preliminary work prior to the start of the 2001 examination, the OTS computed the tax effect on loss classifications before calculating the capital ratios, which increased the capital ratios for PCA purposes. The OTS has not issued any guidelines stating whether this is a permissible activity or outlining circumstances when examiners may use discretion and recalculate the ratios by incorporating a tax effect on loss classifications. The incorporation of the tax effect on loss classifications resulted in higher capital ratios and a more favorable PCA classification for Superior. Since the capital ratios were higher by adjusting the capital deductions, Superior did not reach the critically undercapitalized category until July 2001.

Capital Ratio Calculations at the 2000 Examination

From 1991 until year-end 1999, the OTS assigned Superior either a composite "1" or a composite "2" rating. An examination was conducted with three FDIC representatives on January 24, 2000. Adversely classified assets increased substantially compared to the previous examination. There was notable loss experience in the automobile division and the ALLL was grossly overstated.[52] Additionally, management was unable to support the assumptions used to value the residual interests, which would require a revaluation of the assets and a possible write-down. The following excerpt is taken from the January 24, 2000 OTS examination report.

> *Our findings reduced the capital designation of Superior from a "well capitalized" status, which it has maintained for the past several years, to an "adequately" capitalized status as of December 31, 1999. An "adequately*

[52] The overstatement of the ALLL in itself inflated the capital position since all or a portion of the ALLL, up to 1.25 percent of risk weighted assets, may be included in Tier 2 or supplemental capital. Tier 2 capital is the supplemental capital and consists of the ALLL, cumulative perpetual preferred stock, long-term preferred stock and related surplus, perpetual preferred stock where the dividend is reset periodically, hybrid capital instruments, and term subordinated debt and intermediate-term preferred stock.

capitalized" status is insufficient for Superior's primary business activities. The current examination findings of significant write-offs and the addition of risk-weighted assets reduced the risk-based capital ratio from 10.79 percent to 7.81 percent as of December 31, 1999, prior to any tax considerations for the write-offs. The estimated risk-based capital ratio, after tax considerations, is 8.57 percent.[53]

The FDIC OIG conducted interviews with OTS personnel ranging from field examiners to executive level personnel. When we asked if this type of pre- and post-tax calculation is performed at all OTS institutions, we received conflicting answers. We could not determine based on the varied responses if this calculation was only performed at Superior or if it was a common practice used at other institutions. Field examiners claimed that the calculation of losses on a pre- and post-tax basis was not done at the conclusion of examinations. In a December 21, 2001 letter from the Managing Director of Supervision of OTS, an explanation for this treatment was offered. He stated that the capital ratios reflected in the reports were in compliance with Generally Accepted Accounting Principles (GAAP). Additionally, this process of calculating the pre- and post-tax basis is done on a case by case basis at the OTS's discretion. However, he did not produce any specific OTS guidance pertaining to this issue of calculating capital as requested in the letter. Also, OTS executive level personnel stated that "all regulatory agencies do this." FDIC executive management as well as field examiners and case managers stated that the FDIC does not calculate examination losses on a post-tax basis. We did not survey the Office of the Comptroller of the Currency or the Federal Reserve Board to get their response to this query.

The October 2000 visitation was performed by the OTS with FDIC participation. The purpose of the visitation was to follow up on the January 2000 examination recommendations. The visitation results reflected that Superior's management did not make all of the adjustments to capital recommended in the January 2000 examination report, such as charging off all assets classified loss. Additionally, numerous other deficiencies were noted during the visitation, including the misapplication of accounting principles to the OC account. The visitation report indicated that deficiencies noted in the previous report, which management indicated had been corrected, were still outstanding. The visitation report included a table detailing the calculation of capital including loss classifications using a pre- and post-tax basis. Although the capital ratios were not actually calculated in the report, using the numerical values in the table to calculate the values results in capital ratios detailed in Table 8 below.

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[53] If the pre-tax capital calculation had been used, Superior would have been undercapitalized for PCA purposes.

Table 8: Calculation of Capital Ratios from the October 2000 Visitation of Superior

Capital Ratio	Pre-Tax calculation	Post-Tax Calculation
Total Risk-Based Capital	2.33%	5.20%
Tangible Capital	2.89%	7.19%
PCA Category Based on Capital Ratios	Significantly Undercapitalized	Significantly Undercapitalized

Source: OIG Analysis of data from the OTS 2000 Visitation Report

The visitation report notes that the tax effect was calculated based on a 39 percent tax rate. In fact, Superior was not making money and had no real income against which to offset the losses. There was no evidence that the FDIC objected or approved of the post-tax calculation.

The OTS and the FDIC returned to the bank to conduct an examination as of March 19, 2001. Although there were sizeable losses noted at the examination, it appears that all loss classifications were not deducted from capital in the March 2001 OTS draft examination report. The capital ratios are not reflected in the report with loss classifications on a pre- or post-tax basis. The FDIC draft report stated that if all loss classifications had been deducted from capital, the institution would have been insolvent as of this examination. A review of the OTS workpapers revealed several workpapers where the OTS examiners calculated the capital ratios on a pre- and post-tax basis. The following table details the ratios and the date on which they were calculated for Superior Bank using financial data as of December 31, 2000.

Table 9: Capital Ratios for Superior Bank as of December 31, 2000

Capital Ratio	Date of Calculation	Pre-Tax	Post-Tax
Total Risk-Based Capital	2/12/01	1.88%	4.36%
Tangible Capital	2/12/01	2.42%	5.94%

Source: OTS Examination Workpapers

A July 24, 2001 memo to the Docket File from the OTS Regional Deputy Director, 3 days prior to the closing of the institution, relates the results of the March 19, 2001 examination. The memo states in part:

> *Based upon that reconciliation (between the examination findings and the March 31, 2001 TFR), when applying the examiners' findings, the total equity capital position of Superior is a negative $125.6 million. Superior was not required to make these adjustments due to the Capital Plan conditionally approved by the OTS on May 24, 2001. The shareholders failed to implement the Capital Plan by the implementation date of July 23, 2001, and therefore, the examiners' adjustments must be made.*

The July 25, 2001 version of the capital ratios is detailed in the following table.

Table 10: Capital Ratios for Superior as of July 25, 2001

Capital Ratio	Superior's 3/31/01 calculation	After Examination Adjustments 3/31/01
GAAP Equity	3.15%	(7.16%)
Total Risk-Based Capital	1.47%	(7.18%)

Source: OTS Examination Workpapers

We interviewed the OTS's Chief Accountant on the subject of computing a tax effect on loss classifications in order to recalculate the capital ratios. He stated that calculating the tax effect may be proper; however, in an institution as complicated as Superior, this calculation should not be performed using an effective tax rate. When we reviewed the OTS workpapers, we concluded that the calculations for the December 31, 1999 pre- and post-tax calculations in the January 2000 Report of Examination were performed using an effective tax rate. Consideration was not given to whether the institution was in a position to derive any tax benefit from the transactions even though one workpaper prepared by the regional accountant recommended that the pre-tax ratio be used since Superior's ability to continue as a going concern was questionable. In fact, Superior was not making money and had no real income against which to offset the losses. Accordingly the "post-tax" rate was invalid and should not have been used.

Additionally, we consulted with an FDIC DOS specialist concerning the inclusion of tax affecting loss classifications for determining regulatory capital ratios. His response included the following statements:

> *The banking agencies adopted GAAP as the reporting basis for recognition and measurement purposes in the balance sheet, income statement, and related Call Report schedules in 1997. Then-existing Call Report instructions that departed from GAAP were revised to bring them into conformity with GAAP. However, as the FFIEC and the agencies stated in the attachment to FIL-109-96, dated December 31, 1996, which notified banks about the Call Report revisions taking effect in 1997 adopting GAAP as the reporting basis in the basic schedules of the Call Report will eliminate existing differences between bank regulatory reporting standards and GAAP, thereby producing greater consistency in the information collected in regulatory reports and general purpose financial statements and reducing reporting burden. However, bank regulatory capital ratios will continue to be calculated in accordance with the agencies' capital standards.*
>
> *For examination purposes, when examiners calculate capital ratios as of the examination date and deduct assets classified loss and make deductions from capital for other identified losses, they do not adjust these deductions for any tax effects. Rather, if an institution needs to submit a Capital Plan because it needs to increase capital to some specified level, the institution's plan can show the*

> *actual effect on capital of whatever charge-offs and write-downs it is taking or has taken in response to the examination findings, including any related tax effects, along with the other actions the institution plans to take in order to reach the specified capital level.*

However, we saw no evidence that the FDIC objected or approved of the post-tax calculation.

Comments on Notice of Final Rulemaking Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Residual Interests in Asset Securitization or Other Transfers of Financial Assets

In the Pacific Thrift and Loan Company Material Loss Review,[54] we recommended that the FDIC and the other federal banking regulators continue to pursue amending the capital standards to exclude residual interests based on subprime securitizations from the calculation of capital. A proposed capital standard was issued in 2000 that placed limitations on the amount of residual interests that can be held by insured depository institutions without incurring additional capital charges. Also, the proposal specifies the amount of capital that must be retained for institutions that exceed these limitations. On November 29, 2001, the federal banking authorities announced the publication of a final rule for the revision of the capital standards addressing limitations and capital charges for insured depository institutions that engage in securitization activities.

New Rule to Amend the Regulatory Capital Treatment of Residual Assets

On November 29, 2001 the federal bank and thrift regulatory agencies issued a new rule that changes, among other things, the regulatory capital treatment of residual interests in asset securitizations. The rule, which became effective on January 1, 2002, addresses the concerns associated with residuals that exposed financial institutions like Superior Bank to high levels of credit and liquidity risk. Under the new rule, capital treatment for residual interests would:

- Limit credit enhancing interest-only strips, a form of residual interest, to 25 percent of Tier 1 capital for regulatory capital purposes,

- Require banking organizations to deduct credit-enhancing interest-only strips that are in excess of 25 percent of Tier 1 capital from Tier 1 capital and from assets and to maintain risk-based capital in an amount equal to the face amount of residual interests that do not qualify for the ratings-based approach, and

- Apply a ratings-based approach that sets the capital requirements for asset- and mortgage-backed securities and other positions in securitization transactions (except for credit-enhancing interest-only strips) according to their relative risk using credit ratings from rating agencies to measure the level of risk.

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[54] FDIC OIG's June 7, 2000 Audit Report No. 00-022 *Material Loss Review – The Failure of Pacific Thrift and Loan Company, Woodland Hills, California.*

The dollar for dollar capital requirement, in tandem with the concentration limit will help to ensure that adequate risk-based capital is held against residuals and will limit the amount of residuals that could be recognized for regulatory capital purposes. In our opinion, had Superior Bank operated in accordance with this new rule, it would not have incurred the losses it did and may have avoided failure.

Topic 5 - The effectiveness of the regulators' onsite examination and offsite monitoring of Superior Bank in detecting the institution's problems at an early stage.

From 1993 to 1999, the Office of Thrift Supervision's (OTS) onsite examination and offsite monitoring of Superior was not effective. While OTS examiners were able to identify management's banking activities and to quantify the extent to which these activities impacted the financial statements, OTS did not fully assess all of the risks to the institution. As a result, effective supervisory action was not implemented. In particular, high-risk indicators that warranted further investigation existed early on, but were either not identified, were not followed-up at subsequent examinations, or were not fully addressed by OTS's onsite examination and offsite monitoring processes. Of particular concern were high-risk indicators that eventually led to the failure of the institution. The Federal Deposit Insurance Corporation's (FDIC) onsite examination participation during the January 24, 2000 and March 19, 2001 safety and soundness examinations helped to identify weaknesses and problems within the institution. In addition, the FDIC's offsite monitoring of Superior was effective in detecting potential areas of concern with the institution.

The Board of Directors' Oversight of the Institution

From 1993 to 1999, the Office of Thrift Supervision's (OTS) overall effectiveness in detecting and addressing issues concerning Superior's Board of Directors was limited. The Federal Deposit Insurance Corporation's (FDIC) Division of Supervision (DOS) Manual of Examination Policies states that "the quality of management, which includes the Board of Directors, is probably the single most important element in the successful operation of a bank. In particular, it is extremely important for all members of bank management to be aware of the responsibilities entrusted to them and to discharge those responsibilities in a manner that will ensure the stability and soundness of the institution. In the broadest sense, the board is responsible for the formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. While the selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability, and vigor of the bank are dependent upon an interested, informed, and vigilant Board of Directors." The monitoring, review, and assessment of management adequacy is a very complex and subjective process that interrelates with all of the other rating components used in assessing an institution's performance.

At Superior, several high-risk indicators were present and included the following:

- The domination of affairs of the institution by one individual, the Chairman of the Board.
- The failure to establish adequate policies and procedures. In particular, the board did not impose a capital limitation on the amount of residual assets[55] that could be recorded on the bank's books; the board allowed management to value residual interests based on liberal and unrealistic assumptions; the board did not adopt interagency policy guidelines; the board allowed excessive dividends to be declared and paid; and the board did not adequately protect the institution with sound capital levels.
- The failure to address supervisory recommendations and criticisms. The board did not ensure that corrective action had been properly implemented. As noted above, the board did not ensure that corrective action had been properly implemented in establishing capital limitations, adopting interagency policy guidelines, and preventing excessive dividends. In addition, the board did not ensure that corrective action had been accurately and properly implemented in the submission of Thrift Financial Reports (TFR). Specifically, the board did not ensure that the TFR accurately and properly identified and charged-off adversely classified assets, accounted for the allowance for loan and lease losses, risk-weighted assets for risk-based capital purposes, and accounted for residual interests.
- The failure to ensure adherence to laws and regulations. The board allowed prohibited transactions with affiliates to be conducted.

While all of the above concerns are discussed elsewhere in this report, the OTS's overall effectiveness in detecting and addressing these items as supervisory concerns was limited until the January 24, 2000 Report of Examination (ROE), which was conducted with the FDIC's participation.

Automobile and Mortgage Securitization Activities

Several high-risk indicators were not appropriately addressed or reviewed by OTS. These high-risk indicators included the following:

- the reliance on imputed gains to support earnings and to justify the payment of dividends,
- the level of capital in comparison to (1) the peer group averages and regulatory capital definitions, (2) the risk profile of the institution, (3) the concentration of residual assets, and (4) the reasonableness of dividend payments,
- the valuation of the residual interests and the overcollateralization (OC) accounts,

[55] The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

- the lack of adoption and adherence to interagency policies and procedures, and
- the initiation of new bank activities.

Each of these high-risk indicators is discussed within the following sections.

Earnings

For all ROEs issued on Superior since 1993, OTS did not fully analyze and assess the potential impact of imputed gains on earnings[56] and to the institution. Specifically, imputed gains are generated from the sale of securitized loans, and the calculations used to measure those gains are based on various assumptions and estimates that are subject to change. While OTS identified the volume of imputed gains recorded and noted that the gains were unrealized and subject to change, the OTS did not analyze and assess the bank's performance without those gains or on a realized cash flow basis. In effect, OTS gave undue reliance to non-interest income that was nonrecurring,[57] unrealized, and subject to significant market and economic volatility. Furthermore, OTS assessed the reasonableness of dividends based on the amount of net income, which included the imputed gains recorded into income. OTS did not assess the reasonableness of dividends based on the nature and extent that imputed gains were actually realized by the bank on a cash flow basis.

The volume of imputed gains represented a significant portion of the bank's net income. In particular, imputed gains represented over 120 percent of total net income in 1997 and 1998. If these gains were excluded, the bank would have recognized a net loss in each year since 1995. Furthermore, based on the bank's dividend policy that allowed 50 percent of net income to be allocated to the holding company, cash dividends of $36.6 million and $56 million were declared and recorded during 1997 and 1998, respectively. As a result, if the imputed gains were not fully realized, the dividends distributed to the holding company could erode the bank's capital position.

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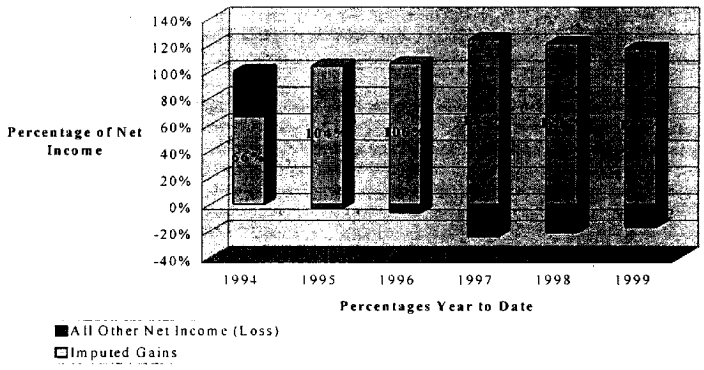
[56] In accordance with the Report of Examination instructions, "Quality and quantity of earnings are evaluated in relation to the ability to provide for adequate capital through retained earnings; level, trend, and stability of earnings; sources of earnings; level of expenses in relation to operations; vulnerability of earnings to market risk exposures; adequacy of provisions to maintain the allowance for loan and lease losses and other valuation reserves; reliance on unusual or nonrecurring gains or losses; the contribution of extraordinary items, securities transactions, and tax effects to net income; and adequacy of budgeting systems, forecasting processes, and management information systems."

[57] The OTS Regulatory Handbook describes nonrecurring sources of income as gains on the sale of assets that are generally unpredictable and unstable. The FDIC DOS Manual of Examination Policies recognizes that the quality of earnings can be diminished by undue reliance on nonrecurring events. In particular, short-term earnings performance can be enhanced by recording current period gains that are generated by the liquidation of high-yielding assets at the expense of future income potential. As a result, the level and trend of earnings could be quite positive; however, future income potential may be sacrificed if funds can only be reinvested at a lower rate of return (or in riskier assets). While Superior's securitization activities made the selling of loans and the recognition of imputed gains recurring events, and a main source of income, in a traditionally run financial institution the liquidation of a loan portfolio would have been considered a nonrecurring transaction that is unusual in nature or infrequent in occurrence. Traditionally, financial institutions generate loans and hold them to maturity, and the main source of income is generated by the interest earned on loans and securities.

Figure 2 illustrates the percentage of imputed gains to net income (before tax) from 1994 to 1999. The figure does not include the bank's performance for the year ended 2000 and for the two quarters ended June 2001, because the bank reported net losses of $11.2 million and $104.8 million which used up the recorded imputed gains of approximately $43.4 million and $0.473 million respectively. Table 11 presents the monetary impact that imputed gains had on net income, and the table presents the percentage of imputed gains needed to be fully realized in order to avoid capital depletion based on the adjusted level of net income and distributed dividends. For analysis purposes, this percentage is similar to a break-even ratio. However, this ratio does not factor in the amount of imputed gains needed to be realized in order to maintain a proportionate level of capital to assets, which can be significant in an institution with a high level of growth. In addition, the table does not show how much the imputed gains were overvalued. This information cannot be determined or estimated based on the data available nor based on the analysis performed within the OTS's ROEs and the FDIC's memorandums to the bank file. However, the assets associated with the generation of the imputed gains, the residual interests and OC accounts, were ultimately written down by $420 million. The OC account was written down by $270 million to correct an accounting error, and the residual interests account was written down by $150 million to correct the use of liberal assumptions in its computation. For both the figure and the table, the information presented is based on the bank's financial performance before taking into consideration tax consequences. This was done to simplify the analysis and to avoid complications associated with the bank's tax structure.

Figure 2: Imputed Gains as a Percentage of Net Income (Before Tax)



Source: OIG Analysis of the Thrift Financial Reports

* Excluding imputed gains, 1994 was the only year that the bank would have recognized a positive level of earnings.

Table 11: Impact of Imputed Gains on Net Income and Dividends Paid

Calendar Year	Net Income Includes Imputed Gains (Before Tax) (000's) A	Imputed Gains** (Before Tax) (000's) B	Net Income Less Imputed Gains (Before Tax) (000's) A–B = C	Dividends Paid (000's) D	Percentage of Imputed Gains Needed to Avoid Capital Depletion (D–C)/B = E
1994	$ 10,915	$ 7,153	$ 3,762	$ *5,793	28%
1995	30,053	31,128	(1,075)	*11,655	41%
1996	60,035	63,535	(3,500)	35,291	61%
1997	73,501	91,314	(17,813)	36,556	60%
1998	113,235	137,103	(23,868)	56,022	58%
1999	159,366	185,979	(26,613)	*33,556	32%

Source: OIG Analysis of Thrift Financial Reports and Reports of Examination

* Amounts include cash and non-cash dividends

** Imputed Gains were reported in the Thrift Financial Reports on the line item entitled "Sale of Assets Held for Sale and Available-for-Sale Securities." This line item was used to establish the dollar volume of imputed gains.

The OTS examiners and supervisors we interviewed justified the examination review and treatment of the imputed gains based on the following:

- The bank's securitization activities were a major focus of business operations,
- Generally Accepted Accounting Principles (GAAP) allowed the recognition of imputed gains into earnings, and
- OTS's Capital Markets Specialist endorsed the assumptions and computations that derived those gains.

In particular, the Field Manager stated, in part, that he would not change the analysis that he or his examiners performed, and that he felt the analysis was accurate and valid. He also stated that he was comfortable with Superior's earnings and that he recognized them as solid. He asserted that the examiners and Capital Markets Specialist did their jobs in reporting the level of activity. Furthermore, he stated that at that time (1996 to 1999), it was their opinion that the bank was complying with the regulations and accounting guidelines, and he did not see any reason why the dividends should not have been approved by the OTS regional office. The Field Manager also clarified that he had nothing to do with the approval of dividends and that the approval process was a function performed by the regional office.

Since 1994, four OTS examiners filled the position of Examiner-in-Charge of seven different full-scope safety and soundness examinations. Collectively, the examiners stated that their rating of earnings was based on the fact that securitization activities were a major part of the bank's business, that the valuation assumptions on the residual interests were endorsed by OTS's Capital Markets Specialists, that reliance was placed on the accountants for what was acceptable reporting, and according to GAAP the bank was allowed to record profits from the sale of loans. In terms of dividend distributions,

one examiner stated that if a bank is issuing dividends within its guidelines, then the examiners do not make an issue out of it. The examiner also stated that the Deputy Regional Director approves dividend distributions and that the field does not approve them.

Despite the above comments, it was still the agency's supervisory responsibility to evaluate imputed gains and dividends and to assess their potential impact on bank operations. In addition, OTS's Regional Deputy Director agreed that a more critical assessment of imputed gains should have been performed. Of particular note, the OTS recommended within the July 6, 1993 ROE that the bank develop a comprehensive dividend policy that considered the impact on capital from those assets (gains) created by the securitization and sale of loans. However, this recommendation was not implemented by the institution, nor did OTS formally follow up and reiterate this recommendation in subsequent examination reports.

The OTS Handbook instructs supervisory personnel to evaluate earnings and its components in relation to their stability,[58] trend,[59] and level.[60] The OTS Handbook recognizes that in assessing the stability of earnings, recurring income sources, such as net interest on loans or investment portfolios, are usually preferable to nonrecurring income sources, such as income derived from the sale of assets. The OTS Handbook further states that a savings association's future viability could be severely affected if it relies too heavily on nonrecurring sources of income. The Operations Analysis Program contained within the OTS Handbook also instructs examiners, in part, to evaluate the composition of earnings, taking into consideration recurring and nonrecurring income sources, and to consider the effect on future earnings potential. OTS's examination reports, going back to 1993, do not reflect the impact of these identified concerns and risks.

The *Interagency Guidance on Asset Securitization Activities*,[61] dated December 13, 1999, highlights that imputed gains resulting from residual interests are subject to significant market and economic volatility. The guidance notes that unforeseen market events can affect the discount rate or performance of receivables supporting residual interests, which can swiftly and dramatically alter the value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate

[58] Stability is defined as the quality, composition, and constancy of income and expense flows relative to internal factors such as credit risks, interest rate risks, or accounting practices, and external factors such as general economic or competitive forces.

[59] Trend is defined as the general direction of the savings association's earnings relative to previous time periods.

[60] Level of earnings is defined as the measure of earnings relative to internal factors such as capital position, credit risk, and interest rate risk.

[61] This securitization guidance issued by the OCC, FDIC, FRB, and OTS highlights the risks associated with asset securitization and emphasizes the regulators' concerns with certain residual interests generated from the securitization and sale of assets. This guidance supplements existing policy statements and examination procedures issued by the federal banking agencies and emphasizes the specific expectation that any securitization-related residual interests claimed by a financial institution will be supported by documentation of the interest's fair value, utilizing reasonable, conservative, valuation assumptions that can be objectively verified.

"paper profits" or mask losses through flawed assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, substantial write-downs of residual interests and, if these interests represent an excessive concentration of the institution's capital, the demise of the sponsoring institution.

The interagency guidance recommends, among various analyses, that a periodic Static Pool Cash Collection Analysis be performed. This analysis entails reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. The interagency guidance also recommends that a comparison be performed of the timing and amount of cash flows received from the trust with those projected as part of the Financial Accounting Standards (FAS) 125 residual assets valuation analysis on a monthly basis. The guidance stipulates that this analysis is essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. In particular, if cash receipts are less than those assumed in the original valuation of the residual interests, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the residual interests.

While OTS's supervisory personnel understood that the imputed gains represented a significant part of net income, were unrealized, and were subject to change, an assessment was not made of the potential impact to the institution should those imputed gains fail to be fully realized. In interviews with OTS's Field Manager and examiners, they did not recognize the need for this analysis. The lack of a proactive review and analysis of the imputed gains resulted in an implied acceptance of the adequacy of the income stream's quality and stability, which resulted in the failure to recommend policy and procedural enhancements that would have limited or mitigated the identified risk. Despite the lack of realized gains, total dividends declared and paid by the institution exceeded $200 million from 1992 to 2001.

Capital Levels

For all ROEs issued on Superior, OTS did not fully analyze and assess the bank's capital adequacy.[62] While OTS supervisors routinely identified the level and trend of capital, certain areas of concern were not fully addressed. In particular, the bank's risk-based

[62]In accordance with the Report of Examination instructions, "Capital adequacy is evaluated in relation to supervisory guidelines; the nature and extent of risks to the organization, and the ability of management to address these risk; consideration is given to the level and quality of capital and overall financial condition of the institution; the nature, trend and volume of problem assets and the adequacy of the allowance for loan and lease losses and other valuation reserves; risk exposures presented by off-balance sheet activities; quality and strength of earnings; balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and nontraditional activity risk; growth experiences, plans, and prospects; reasonableness of dividends; access to capital markets and other appropriate sources of financial assistance; and ability of management to address emerging needs for additional capital."

capital ratio[63] remained below peer levels, capital calculations were not consistently reviewed and enforced, and significant capital concentrations existed. In addition, the reasonableness of dividends was not assessed based on the nature and extent of imputed gains that were recognized as earnings. (Refer to Topic 7 for additional information on the dividend payments.) Furthermore, the supervisory analysis conducted at this institution supported capital adequacy based on the bank's commitment to maintain and adhere to the regulatory capital definitions. In effect, OTS did not require or evaluate this institution's capital adequacy based on the institution's particular risk profile, and capital was not maintained commensurate with the institution's level and nature of risk exposure.

In assessing capital adequacy, OTS supervisory personnel consistently identified that the institution's tangible and core capital ratios exceeded its peer group median, while the risk-based capital ratio remained below the peer average. While OTS identified that the risk-based capital ratio was below the peer group median, the significance of this ratio was not emphasized in evaluating capital adequacy. In particular, this ratio is a measure of the level of capital available based on the risk profile of an individual bank. Conversely, OTS emphasized the significance of the tangible and core capital ratios, which indicates the extent to which capital was leveraged. However, these two ratios (tangible and core) fail to reflect the risk associated within the bank's asset structure and more specifically within the residual assets. Furthermore, all three ratios (tangible, core, and risk-based) are subject to overvaluation and manipulation by potentially liberal assumptions used in calculating and valuing the residual interests and OC accounts. In addition, these ratios do not take into consideration the additional capital needed to protect the institution against the risk created from the bank's unique risk profile, which included, among other things, the presence of a high capital concentration level of residual assets and significant subprime[64] lending activities.

Table 12 below details the bank's capital ratios in comparison to peer averages as presented in the ROEs since 1996. These ratios are presented as they were detailed within OTS's ROEs. The ratios were not readjusted to capture any subsequent correction to the bank's financial statements that were identified at later examinations. As can be expected, if the changes in estimated asset values and the identification of accounting errors were identified and applied in an earlier period, the value of the bank's assets and the amount of capital would decrease. As a result, the bank's risk-based capital ratio would fall further below the peer average, as was eventually recognized in the financial statement dated March 31, 2001.

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[63] The risk-based capital ratio is calculated by dividing an institution's qualifying total capital base by its risk-weighted assets. The risk-weighted assets are calculated by assigning assets and off-balance sheet items into broad risk categories. The risk weightings range from 0 percent (for assets backed by the unconditional full faith and credit of the United States), to 100 percent (for many types of assets not qualifying for more favorable risk weighting). Off-balance sheet commitments are converted to "credit equivalent" amounts by a conversion factor. The credit equivalent amounts are then risk weighted in accordance with the rules used for balance sheet assets.

[64] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

Table 12: Bank Versus Peer Average Capital Ratios

Financial Statement Date	Tangible and Core Capital Ratios*		Risk-Based Capital Ratio	
	Bank	Peer	Bank	Peer
03/31/01	2.2%	7.4%	1.5%	11.7%
12/31/99	10.5%	7.6%	7.8%	11.7%
12/31/98	12.0%	7.6%	10.0%	12.6%
09/30/97	12.9%	7.2%	10.7%	13.0%
06/30/96	10.2%	7.3%	11.2%	14.2%

Source: Reports of Examination and Uniform Thrift Performance Report
* Tangible and Core Capital Ratios were the same in all periods.

Moreover, capital calculations were not consistently reviewed. In the August 8, 1994 and the September 11, 1995 ROEs, OTS examiners notified Superior's management of errors in the capital calculations. Specifically, the 1994 ROE cited the bank for including an allowance for investment loss in the supplemental section of risk-based capital. The amount was attributed to excess mortgage servicing rights and was documented as not being eligible for risk-based capital purposes. This issue was noted again during the 1995 examination and OTS repeated the criticism. However, after the 1995 examination, the bank still did not initiate corrective action, and OTS did not follow up to ensure corrective action had been taken. During the January 24, 2000 examination, OTS found again that the bank was using an allowance in the valuation of the residual assets and was inappropriately including the amount in supplemental capital. Furthermore, at this examination OTS also began to question management's ability to substantiate the existence of this allowance. The failure to review and address prior examination criticisms and recommendations appears to be an error in the oversight process. The OTS Regulatory Handbook requires, and supervisory personnel interviewed stated, that prior examination criticisms should be followed up and reviewed at the subsequent examination.

Significant capital concentrations existed. (Refer to Topic 2 for additional information on the level of concentrations of residual assets.) As these concentrations grew, the examiners did not criticize the concentration's size, and no recommendations were made to limit further growth. Only in the August 8, 1994 ROE did examiners note and recommend corrective action for the lack of a limitation on excess mortgage servicing rights investment levels. Although the OTS discussed the volume of securitization and residual assets at subsequent examinations, no specific criticisms were made and no recommendations were presented to limit the level of investment in these assets or to follow up on the recommendation made in the 1994 ROE.

In interviews with OTS's examiners and other supervisory personnel, several individuals stated that they did not identify the concentration level as a concern, nor was it their responsibility to determine or to recommend that a concentration limitation be placed on an institution or to stipulate that more capital was needed. In particular, the OTS Field Manager stated, in part, that OTS had identified the concentration, but they had not formulated any concerns. He stated that there was no reason to curtail the bank's activities in 1996 and 1997, the bank was making "big money," and it was not until 1999

that the concentration level became an issue. Regardless, the Field Manager stated that the bank was a unique institution and that was how it chose to make its money, and OTS felt comfortable with what the bank was doing. Conversely, in an interview, the OTS Capital Markets Manager stated that he felt capital was insufficient based on the bank's activities and risk profile. However, he stated it was not his responsibility to assess capital, nor was it his responsibility to report his concerns to others. The Field Manager, however, did state that he had a conversation with the Capital Markets Manager, but he could not recall the details. Regardless, the Field Manager mirrored the Capital Markets Manager's statements by stating that no one was going to request more capital, because examiners don't have any "black and white" methodology to say how much capital is needed. He further clarified that it was not his, the Capital Markets Manager's, or the examiners' responsibility to say if a bank needs more capital, because they have nothing to "hang their hat on," and they don't know how much. However, they do determine the adequacy of capital. He also stated that he and the examiners set the ratings and Washington could have changed them, but no one was willing to make the statement that capital was less than adequate or insufficient. One examiner also stated that the examiners' responsibilities end with a discussion of the concentration in the ROE and that any final decisions or actions are up to the regional office. However, the *Interagency Guidance on Asset Securitization Activities*, dated December 13, 1999, stipulates that "consistent with existing supervisory authority, the agencies may, on a case-by-case basis, require institutions that have high concentrations of these assets (residual interest) relative to their capital...to hold additional capital commensurate with their risk exposures." The interagency guidance also emphasizes the need for internal limits to be put into place to govern the maximum amount of residual assets as a percentage of total equity capital.

Capital adequacy was routinely supported by the bank's adherence to regulatory capital definitions as an indicator of capital adequacy. In particular, OTS utilized minimum leverage and risk-based capital standards and the "well capitalized" and "adequately capitalized" definitions that are used in the Prompt Corrective Action regulations to support the assessment of capital adequacy. This treatment is supported, in part, by OTS's Regulatory Handbook that stipulates that meeting regulatory capital requirements is a key factor in determining capital adequacy. However, OTS's guidance also stipulates that the institution's operations and risk position may warrant additional capital beyond the minimum regulatory requirements, and examiners are directed to determine whether capital is adequate in relation to the risk profile and operations of the bank. The FDIC's DOS Manual of Examination Policies also recognizes a distinction in what is adequate capital for safety and soundness purposes versus adherence to regulatory minimum leverage and risk-based standards. The FDIC recognizes that the minimums set forth in the leverage and risk-based capital standards apply to sound, well-run banks, and that most banks are generally expected to maintain capital levels above the minimums, based on the institution's particular risk profile.

Based on interviews, an over-reliance existed on the owners' ability to provide additional support if needed; however, this view was not formally presented within the ROEs as a mitigating factor except to the extent that management intended to maintain a "Well

Capitalized" position. In addition, this assumption was never supported by the actions of the owners. In fact, professional skepticism should dictate that reliance on the owners would only be justified if similar actions had been demonstrated previously. Secondly, some examiners stated that they did not feel it was their place to recommend a capital concentration limitation or to require a capital injection. However, this view appears to go against the basic philosophy and supervisory responsibility that all regulators hold to assess the safety and soundness of institutions. Lastly, the level of understanding and comprehension of the nature of risk evident in the risk-based capital ratio, capital concentrations, and dividend payments may have been a factor. OTS's supervisory personnel did not fully analyze and assess the risk to capital and to the institution, because of a general lack of awareness and knowledge of the need to proactively identify, measure, assess, and limit/mitigate potential risk to an institution.

Regardless of whether OTS over-relied on management's assertions, did not take responsibility for criticizing concentration and capital levels, or did not have a full level of understanding and comprehension of the nature of risk present, OTS allowed risk-based capital levels to remain below the bank's peer group median. If, at a minimum, OTS had required risk-based capital to increase to a level commensurate with the bank's peer average, the bank would have needed to significantly increase capital. At a minimum, the additional level of capital needed as of December 31, 1999, would have equaled a range from 16.0 percent to 19.8 percent of the estimated losses to the insurance fund of $426 million to $526 million as of the date of closure. The minimum required capital injections are presented below, in Table 13, as of the financial statement date. This comparison, however, is based on the bank's peer group which is largely composed of financial institutions that are traditionally run, possess lower risk profiles, and do not have high concentrations in high-risk assets. The presence of these additional risk factors in Superior was not captured by the risk-based capital ratio and should have prompted even greater increases in capital levels. For example, based on comments made by Director Reich in an article entitled *FDIC Head: Superior's Lessons Are Old Ones*, dated August 21, 2001, the average common equity capital ratio for non-bank subprime lenders equaled 22.5 percent in 1998. Director Reich noted that this level of capitalization occurs because market pressures force non-bank lenders to hold more reserves in order to attract investments. Furthermore, the analysis presented below also assumes that all of Superior's assets were accurately valued and accounted for as presented in the ROEs. By increasing the institution's expected level of capital, OTS could have halted dividend payments and slowed the growth of the institution, which would have also limited the losses to the deposit insurance fund.

Table 14 illustrates the impact on dividends that would have occurred if the bank had been expected to maintain the risk-based capital ratio at a level equal to its peer group average and at 300 basis points above its peer group average. As the data shows, dividends could have been halted in 1996 and substantially reduced thereafter. Furthermore, if this analysis was coupled with the analysis discussed earlier on earnings and imputed gains, any payment of dividends could have been deferred until the imputed gains were realized on a cash flow basis. While an analysis of when the imputed gains were realized was not performed due to the lack of available information, a deferment of

one year on the 300 basis point increase scenario and a deferment of two years on the minimum capital scenario would effectively support halting all dividend payments. The safety and soundness examinations conducted in 1994 and 1995 were excluded from the tables below due to the lack of a quoted peer risk-based capital ratio within OTS's ROEs.

Table 13: Minimum Capital Shortfall Based on the Risk-Based Capital Ratio Differential

Financial Statement Date	Risk-Based Capital Ratio		Ratio Differential	Total Assets (000's)	Capital Shortfall (000's)
	Bank A	Peer B	A-B = C	D	C*D = E
03/31/01	1.5%	11.7%	(10.2%)	$ 1,941,439	$ 198,027
12/31/99	7.8%	11.7%	(3.9%)	2,161,443	84,296
12/31/98	10.0%	12.6%	(2.6%)	1,801,705	46,844
09/30/97	10.7%	13.0%	(2.3%)	1,184,351	27,240
06/30/96	11.2%	14.2%	(3.0%)	1,037,609	31,128

Source: OIG Analysis of OTS Reports of Examination

Table 14: Capital Shortfall Comparison to Dividends Paid

Financial Statement Date	Minimum Capital Shortfall (000's) A	Capital Shortfall Based on a 300 Basis Point Increase Above Peer Ratios (000's) B
03/31/01	$ 198,027	$ 256,269
12/31/99	84,296	149,139
12/31/98	46,844	100,895
09/30/97	27,240	62,770
06/30/96	31,128	62,256

Calendar Year	Dividends Paid (000's) C	Cumulative Dividends Paid Since 1996 (000's) D	Cumulative Dividends Available Based on Minimum Capital Shortfall (000's) D-A = E	Cumulative Dividends Available Based on Capital Shortfall - 300 Basis Point Increase Above Peer Ratios (000's) D-B = F
2000 & 2001	$ 0	$ *161,425	$ (36,602)	$ (94,844)
1999	*33,556	*161,425	77,129	12,286
1998	56,022	127,869	81,025	26,974
1997	36,556	71,847	44,607	9,077
1996	35,291	35,291	4,163	(26,965)

Source: OIG Analysis of OTS Reports of Examination
* Amount includes cash and non-cash dividends.

The Valuation of Residual Interests and the Overcollateralization Accounts

OTS's early onsite examination and offsite monitoring processes used to detect problems in the valuation of residual interests and in the OC accounts were not effective. As discussed elsewhere in this report, OTS over-relied on management assurances and on Superior's external auditor's opinions when assessing the value of the bank's residual

interests and OC accounts. (Refer to Topic 3 for a detailed discussion of Ernst &Young.) When Superior began the securitization process, OTS reported on the bank's valuation assumptions during their safety and soundness examinations. In 1996, the OTS brought in a Capital Markets Specialist from the Southeast Region to review all of the bank's residual assets. Based on this review, the ROE did not note any deficiencies with the assumptions that Superior was using to value the residual interests. Furthermore, the two subsequent examinations also did not note any deficiencies. However, the documentation used to support, and the examination methodology used to substantiate management's assumptions, were not detailed within the ROEs. Following the January 25, 1999 examination, Superior clearly liberalized its assumptions, which increased the value of the residual interests. Both the FDIC and the OTS participated in the January 24, 2000 examination, and both agencies criticized Superior's unsupported assumptions. It is unclear how these liberal assumptions were supported and whether they were implemented with or without the board's approval. Furthermore, it is unclear how the bank's policies, procedures, or processes changed from what had been done in the earlier years due to the lack of detail provided in OTS's ROEs.

Interagency Policies and Procedures

Superior began the automobile loan program in 1994. However, for all ROEs issued on Superior from 1994 to 1999, OTS identified the level and trend of loan underwriting and asset securitization activities, but adherence to the standard interagency policy guidance was not enforced. OTS did not enforce the *Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status*, (1980 Policy) issued June 30, 1980,[65] and OTS did not fully enforce the *Uniform Retail Credit Classification and Account Management Policy* (Uniform Policy) issued February 10, 1999,[66] and the revisions to the Uniform Policy (Revised Policy) issued June 12, 2000.[67] The Uniform

[65] On June 30, 1980, the FRB, FDIC, and OCC adopted the Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status (1980 Policy). The Federal Home Loan Bank Board, the predecessor of the OTS, adopted the 1980 policy in 1987. The 1980 policy established uniform guidelines for the classification of retail installment credit based on delinquency status and provided charge-off time frames for open-end and closed-end credit. The 1980 Policy required examiners to follow the general classification policy during examinations of commercial banks:

- Closed-end consumer installment credit delinquent 120 days or more (5 monthly payments) will be classified Loss, and loans delinquent 90 to 119 days (4 monthly payments) will be classified Substandard.
- Open-end consumer installment credit delinquent 180 days or more (7 zero billing cycles) will be classified Loss, and loans delinquent 90 to 179 days (4 to 6 zero billing cycles) will be classified Substandard.

[66] On February 10, 1999, the banking agencies issued the Uniform Retail Credit Classification and Account Management Policy (Uniform Policy). In general, the Uniform Policy:

- Established a charge-off policy for open-end credit at 180 days delinquency and closed-end credit at 120 days delinquency.
- Provided guidance for loans affected by bankruptcy, fraud, and death.
- Established guidelines for re-aging, extending, deferring, or rewriting past due accounts.
- Provided for classification of certain delinquent residential mortgage and home equity loans.
- Provided an alternative method of recognizing partial payments.

[67] Due to a subsequent modification, the effective date for fully implementing the Uniform Policy was extended to December 31, 2000. On June 12, 2000 the Uniform Policy was revised to clarify various items

Policy was first utilized during the January 24, 2000 OTS safety and soundness examination that FDIC participated in; however, compliance with the policy guidelines was not strictly enforced. In effect, OTS allowed management to delay and under-report adverse loan classifications and to overstate loan portfolio and capital values.

Based on the FDIC's January 24, 2000 memorandum to the file, regarding the OTS safety and soundness examination, substantially all automobile loans originated were considered subprime and were originated with the intent of securitizing and selling them in the secondary market. From the inception of the automobile loan program in 1994 to December 1999, the bank originated approximately $884 million in automobile loans with an average interest rate of 17.7 percent. At the height of operations, from April 1998 through September 1999, Superior originated approximately $493 million in automobile loans, which represented 56 percent of the total dollar volume of all automobile loans originated. As of December 31, 1999, automobile loans reported on the bank's balance sheet totaled $274 million and equaled 29 percent of total loans outstanding of $934 million.

Superior retained significant off-balance sheet risk from automobile loan securitization activities due to the existence of loan recourse arrangements. Prior to 1999, automobile loans were securitized and sold under a recourse arrangement in which Superior was required to repurchase nonperforming loans. In 1999, automobile loans were securitized and sold with an allowance for loan losses equating to approximately a 15 percent loss-rate factor; however, if that cushion became depleted Superior would still be required to fund credit losses. Loans on the bank's books included newly originated loans held for sale, loans originated for sale that became delinquent before a sale could be consummated, and nonperforming loans which the thrift was obligated to repurchase under the recourse agreements. Based on an interview, the OTS Field Manager speculated that the losses incurred by the bank in the automobile portfolio might have contributed to management's decision to lower credit underwriting standards in the mortgage portfolio and to increase the valuations of the residual interest accounts. If true, these actions would have resulted in a short-term increase to earnings and capital, while increasing the long-term risk to the institution. Table 15 shows the amount of automobile loans outstanding and charged-off in relationship to total loans outstanding and charged-off from 1994 to 2001.

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within the policy with respect to (1) the re-aging of open-end accounts; (2) extensions, deferrals, renewals, and rewrites of closed-end loans; (3) examination considerations; and (4) the treatment of specific categories of retail loans.

Table 15: Automobile Loans and Related Losses

Calendar Year	Total Loans (000's) A	Total Loans Charged-Off (000's) B	Total Auto Loans (000's) C	Total Auto Loans Charged-Off (000's) D	Total Auto Loans as a Percent of Total Loans C/A	Total Auto Loans Charged-Off as a Percent of Total Loans Charged-Off D/B
1994	$ 507,998	$ 894	$ 6,225	$ 0	1%	0%
1995	504,632	1,418	68,813	0	14%	0%
1996	402,344	6,773	17,761	2,420	4%	36%
1997	466,917	17,584	28,830	6,805	6%	39%
1998	648,496	30,907	225,016	777	35%	3%
1999	934,036	45,525	273,970	21,658	29%	48%
2000	588,503	*154,927	65,488	6,157	11%	*44%
2001**	416,994	29,410	2,386	27,878	1%	95%

Source: OIG Analysis of Thrift Financial Reports and OTS's Reports of Examination
*This number includes the charge-off of other assets totaling $141 million. This amount was reflected in the column Total Loans Charged-Off, but was excluded from the ratio calculation of Total Automobile Loans Charged-Off to Total Loans Charged-Off. This number is attributed, in part, to the $125.9 million reduction that was required at the conclusion of the 2000 examination. This reduction was required to exclude unsubstantiated funds that were in the allowance for loan and lease losses.
**This period is for the six months ended June 30, 2001.

In assessing the automobile loan portfolio,[68] OTS supervisory personnel consistently identified the level and trend of loan underwriting and asset securitization activities. In the October 27, 1997 ROE, OTS examiners first identified that management failed to classify delinquent automobile loans and repossessions in regulatory/supervisory reports. The examiners noted that automobile loans delinquent 90 to 119 days and repossessed automobiles were not classified. Then again in the January 25, 1999 ROE, OTS examiners noted management's failure to classify certain automobile loan accounts. These accounts dealt with balances involving:

- deficiency amounts due after collateral liquidation entitled "Liquidated Deficiency" ($13.6 million),
- delinquent borrowers who were hiding their automobile from repossession entitled "Note Suits" ($9.3 million),
- loans held for sale that were past due at least 3 months ($.5 million), and

[68] In accordance with the Report of Examination instructions, "Asset quality is evaluated in relation to the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on- and off-balance sheet; the adequacy of the allowance for loan and lease losses and other valuation reserves; demonstrated ability to identify, administer and collect problem assets; the diversification and quality of loan and investment portfolios; the adequacy of loan and investment policies, procedures, and practices; extent of securities underwriting activities and exposure to counterparties in trading activities; credit risk arising from or reduced by off-balance sheet transactions; asset concentrations; volume and nature of documentation exceptions; effectiveness of credit administration procedures, underwriting standards, risk identification practices, controls, and management information systems."

As presented within the ROE, these account balances totaled $23.8 million, and were comprised of amounts that were inappropriately classified by management. Excluding the loans held for sale, all of the above balances should have been charged-off in accordance with interagency policy guidelines; however, OTS allowed approximately $10.7 million to remain on the bank's books. No reference was made to the 1980 Policy or to the Uniform Policy.

OTS first utilized the Uniform Policy during the January 24, 2000 examination in which the FDIC participated. However, OTS's interpretation and guidance were liberal and did not thoroughly reflect Uniform Policy guidelines. In particular, OTS stipulated that the Uniform Policy allowed institutions to avoid a 100 percent charge-off by determining the fair value less selling cost of the collateral and charging off the book balance for any amounts in excess. Management was also informed that the Uniform Policy stipulated that valid insurance claims could be used to support an asset. Based on these two positions, approximately $22 million was not charged-off by OTS. Alternatively, OTS requested that management perform a review and make any necessary corrections. Before performing a review, management had stated to OTS that the loans in question were adequately protected by the loans' collateral values, and any resulting charge-off would be unlikely. OTS also recommended that the bank amend its policies to reflect a charge-off to retail closed end credit upon 120-day delinquency, unless the loan is well secured.[69] The guidance provided by the OTS did not coincide with the definition of "well secured and in the process of collection," and the presence of specific allowances on these accounts cast doubt about management's ability to reasonably collect on these loans regardless of delinquency status.

OTS's interpretation and guidance also did not thoroughly reflect the guidance provided in the Revised Policy. While not issued until June 12, 2000 and not presented by the OTS, the Revised Policy provided further clarification on classifying loans that become severely delinquent.[70] While this guidance would have allowed management to avoid a 100 percent charge-off on automobile loans that were 120 days past due, OTS did not assess the bank's process of establishing the value of the collateral. In addition, OTS did not provide guidance of when repossession of the collateral is "assured and in process." The Revised Policy also provided specific guidance for customer accounts in bankruptcy status. Accounts in bankruptcy should be charged-off within 60 days of receipt of

[69] The Uniform Policy stipulates, "If an institution can clearly document that the delinquent loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities, with an estimated fair value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. In the process of collection means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days."

[70] The Revised Policy stipulates, "Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified Loss and charged-off. In lieu of charging off the entire loan balance, loans with non-real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process."

notification of filing from the bankruptcy court or within the 120-day time period specified within the policy statement, whichever is shorter, unless the institution can clearly demonstrate and document that repayment on accounts in bankruptcy is likely to occur. OTS did not request and/or management did not provide this documentation.

In the March 19, 2001 ROE, examiners reported that management tracked the actual loss experience for each type of segregated asset group in order to determine estimated losses. These loss experience ratios were then utilized as the basis for a partial charge-off of all dollar amounts in the 120 days delinquent category. The methodology used by management and allowed by OTS conflicts with the guidance presented in the prior ROE and with the Uniform and Revised Policies.

The following table summarizes the amounts questioned and charged-off by OTS for the last three safety and soundness examinations conducted. The amounts not charged-off and not reviewed in accordance with interagency guidelines, represents the additional loss not recognized by the bank that could have potentially been charged-off if the interagency policy had been strictly adhered to and enforced.

Table 16: Automobile Balances Reviewed by OTS

Financial Statement Date	Questioned Auto Loan/Asset Amounts (000's)	Amounts Charged-Off (000's)	Amounts Not Charged-Off and Not Reviewed in Accordance with Interagency Guidelines (000's)
03/31/01	$ 9,697	$ 0	$ *9,697
12/31/99	73,739	**47,400	***21,992
12/31/98	23,790	12,498	11,292

Source: OIG Analysis of OTS Reports of Examination

* This amount consisted of loans in bankruptcy status, pending insurance claims, and repossessed automobiles.

** Of the $47.4 million, $31.8 million was derived from two accounts discussed in the previous year, which OTS did not require the bank to fully charge-off. These accounts were entitled Liquidated Deficiencies and Note Suits and were recognized as the most severely impaired accounts.

*** This amount represents the balance of four loan categories that were 120 days past due. The four loan categories were entitled Bankruptcy, Insurance Claims, Assigned for Repossession, and Repossessed Automobiles. Specific allowances for loan losses were outstanding on these accounts and totaled $4.3 million. The specific allowance equaled 17 percent on the outstanding loan balance not charged-off of $26.3 million.

Examination guidance implementing the interagency policy was provided within the OTS Regulatory Handbook. Based on interviews, the Examiner-in-Charge of the October 7, 1996 examination stated that the bank had just begun operations in the automotive lending area and the amounts were not material enough to perform a detailed review. The examiner-in-charge of the January 25, 1999 examination noted that the bank was not using the Uniform Policy to classify automobile loans; instead, Superior was using a historical loss experience method. The OTS examiner stated that he chose not to follow the policy guidance and that Superior's process seemed adequate. The examiner also stated that he felt he would just report the bank's review process and let the regional office decide what to do. The lead FDIC examiner, of the January 24, 2000 examination,

stated that the OTS examiners were unfamiliar with the policy and with its requirements. The OTS examiner-in-charge of the January 24, 2000 examination, stated that the bank was still using a historical analysis method to classify the automobile loans, and the bank should have complied with the interagency policies; however, the FDIC and the OTS did not agree with what the policy required. Based on discussions with OTS's senior management, they indicated that the OTS fully supports and intended to comply with all interagency policies. OTS senior management also did not know why the interagency policies were not followed.

The total loss experienced by the bank due to automobile lending and securitization activities was significant. Based on the amount of loss reported within the bank's TFRs total losses recorded from the automobile loan portfolio equaled approximately $66 million. This balance does not include the cost of terminating the automobile loan operations. In addition, when examination review procedures are implemented during the initial phases and offerings of new programs and products, areas of potential concern can be identified and measures can be recommended to limit and/or mitigate risk to an institution. The delay in implementing the interagency policies resulted in OTS becoming reactive to mounting loan underwriting and classification problems, and allowed management to delay and under-report adverse loan classifications and to overstate loan portfolio and capital values.

New Bank Activities

As noted in the preceding section, Superior began the automobile loan program in 1994. However, a comprehensive review of the bank's policies, procedures, and projections was not performed when the automobile loans were first offered. In particular, changes in operations, which include offering new loan products, can pose significant risk to an institution. Regardless of the level of current activity, consideration has to be given to the significance of the projected level of operations and resource allocation. Furthermore, the ROEs did not mention management's plans to initiate automobile loan activities within discussions of the bank's budget and strategic plans. While OTS identified the level and trend of loan underwriting and asset securitization activities, in-depth reviews were only performed after the loan balances represented a material portion of assets. As a result, target ratios, parameters, and controls used to limit/mitigate risk could have been recommended by OTS and implemented by management, but were not.

The OTS Regulatory Handbook states that scoping an examination requires a special emphasis on risk analysis and prioritization. The depth of review varies in each area according to the institution's size, activities, and condition. Examiners are expected to perform less of a review in those areas where no significant present or potential risk exists and to perform more of a review where major risk is present or possible. Examiners are also reminded that major areas of risk do not necessarily mean problems; some risk is part of operating any profitable institution. Examiners are to include procedures that enable them to determine if the institution's level and management of risk are unsafe and unsound. They are also instructed to concentrate on changes in operations or management because these can pose significant risk. The OTS Handbook also

requires a review of policies and procedures when assessing an institution's consumer lending portfolio, and specific reference is made to reviewing an institution's compliance/adherence to the Uniform Policy.

While the OTS Regulatory Handbook instructs examiners in how to risk focus and scope an examination, Superior's automobile lending area was not identified as an emerging risk. The Examiners-in-Charge of the 1994, 1995, and 1996 examinations stated that a comprehensive review of the automobile lending area was not performed because the activity was not material. The Examiner-in-Charge of the 1996 examination also stated that he believed that management's plans to enter the automobile lending area were not sound and that management lacked the necessary expertise. However, despite this view, he stated that an examiner can only deal with what exists at the time and that restrictions or capital requirements cannot be imposed until you start having losses.

The effect of not performing a comprehensive review on a new and emerging area of activity was a delay in the assessment and oversight of this activity. Furthermore, the scale of the bank's planned activity was not fully considered in assessing risk or in evaluating the safety and soundness of the institution. As a result, potential weaknesses in operations and management expertise were not identified, and target ratios, parameters, and controls used to limit/mitigate risk were not recommended or implemented. Similar to the previous section concerning the bank's adherence to interagency policies and procedures, the delay in following and implementing OTS's regulatory examination guidelines resulted in OTS becoming reactive versus proactive to mounting loan underwriting and classification problems.

Federal Deposit Insurance Corporation

From 1993 through 1999, the FDIC did not materially[71] participate in the onsite examination process of Superior. However, the FDIC did participate in the last two safety and soundness examinations that were conducted. The FDIC's onsite examination participation during the January 24, 2000 and March 19, 2001 safety and soundness examinations identified weaknesses and problems within the institution. During the 2000 examination, the FDIC had a limited focus that centered primarily on the following areas: residual interests and securitization activities, valuation reserves and capital, audit and independent review programs, asset quality, and management. The activities reviewed by the FDIC during the 2001 examination were centered on servicing operations, securitization program, and retail bank/accounting department operations. During these examinations, the FDIC helped to identify weaknesses involving the Board of Directors' oversight of the institution, automobile and mortgage securitization activities, and valuation of residual interests and the OC accounts.

The FDIC's offsite monitoring of Superior was effective in detecting potential areas of concern with the institution in 1998 and 1999; however, earlier OTS ROEs exhibited weaknesses that the FDIC did not address. Specifically, in September 1998 the FDIC recognized that Superior exhibited a high-risk asset structure, possessed significant

[71] FDIC participated in a concurrent visitation, dated July 3, 1993.

investment concentrations in residual interest securities and high coupon loans held-for-sale, had a high past due loan ratio, and had increasing levels of repossessed assets. In addition, the FDIC noted that Superior had substantial recourse exposure in loans "sold" through its securitization program, and the FDIC identified that discrepancies existed between TFR data and audited financial statements concerning the allowance for loan and lease losses. Furthermore, the FDIC noted that the operating characteristics of the institution were uncommon in the region and were deserving of further investigation. While the high past due loan ratio was an emerging issue in 1998, the other particular concerns were evident in previous years and were not questioned by the FDIC. In addition, the FDIC did not recognize the inherent risk that existed in the over-reliance on imputed gains to support earnings and to justify the payment of dividends; the FDIC did not recognize that while capital ratios exceeded regulatory minimums for the definition of "well capitalized" more capital was needed; and the FDIC did not question OTS's lack of follow up on previous examination recommendations.

Other high-risk indicators that were discussed previously would have been difficult for the FDIC, as the back-up regulator, to ascertain through offsite monitoring. These other indicators include such as items as:

- noncompliance with statutory rules and regulations,
- supervisory over-reliance on management and the external auditors in establishing, supporting, and verifying the appropriate valuations of the residual interests and OC accounts,
- noncompliance with GAAP,
- the lack of adoption and adherence to interagency policies and procedures, and
- the lack of review of new bank activities.

The cause of the FDIC's delay in initially detecting potential areas of concern through the offsite monitoring process is uncertain. However, when the FDIC did begin to detect potential problems in 1998, a new Case Manager and Assistant Regional Director had been assigned oversight responsibility for Superior. The Case Manager was recognized as possessing expertise in the areas of accounting and capital markets.

An earlier response by the FDIC could have potentially slowed the growth of the institution and limited the exposure to its high-risk activities. As a result, losses could have been limited and the bank's failure possibly prevented. Conversely, losses could have been greater if the FDIC had not initially identified its supervisory concerns and requested to participate in subsequent OTS examinations.

Topic 6 - The effectiveness of the supervisory actions taken by the regulators in addressing the problems identified during their onsite examinations and offsite monitoring process.

Owing to the presence of limited regulatory criticism identified during the 1990s, the Office of Thrift Supervision took no regulatory supervisory actions against Superior until July 2000. By the time this action was taken, the continued viability of the institution was dependent upon a capital injection. The FDIC helped to identify weaknesses and problems within the institution during its onsite examinations and offsite monitoring processes. However, regulatory authority limited the FDIC's actions and effectiveness.

Regulatory Supervisory Actions

OTS undertook limited regulatory supervisory actions. The first regulatory supervisory action taken was the issuance of a directive under 12 CFR Part 570 in July 2000. This directive stipulated that the bank was to develop a safety and soundness corrective program that addressed, in part, residual interests valuations, residual assets[72] concentrations, internal controls, credit underwriting, allowance for loan and lease losses policies and procedures, and asset quality. In October 2000, OTS conducted a bank visitation that reviewed management's compliance with the directive and with other recommendations made from the January 2000 examination. No other regulatory corrective actions were issued until February 2001, when OTS issued a PCA directive to Superior and a cease and desist order against the bank's first and second tier holding companies. While the bank submitted a capital restoration plan in accordance with the PCA notice in March 2001, the plan was deemed unacceptable. After three amendments and two revisions, the OTS accepted and approved the capital restoration plan in May 2001. However, in July 2001, owners of the bank notified the OTS that the Capital Plan would not work, and OTS closed the bank and named the FDIC as receiver.

OTS's Application of the Provisions of Prompt Corrective Action

Section 38 of the FDI Act, Prompt Corrective Action 12 USC §1831(o), was created to resolve the problems of insured depository institutions to achieve the least possible long-term loss to the deposit insurance funds. It also requires each federal banking authority to establish minimum capital levels to assist in the regulation and implementation of this section. Section 38 stratifies institutions into five different capital categories. These categories range from the highest group referred to as "well capitalized" to the lowest

[72] The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

sector known as "critically undercapitalized," with three intermediate stages. As the capital categories descend from well capitalized to the lower levels, the law applies more restrictions to institution activities, and the federal banking agencies are required to take increasingly severe actions to attempt to halt the deterioration in the institution. These actions range from restricting certain activities, such as asset growth and dividend payments, to closing institutions that remain in a critically undercapitalized state.

Because of the lack of accurate information from 1993 until the end of 1999, it is impossible to determine if the OTS applied the provisions of PCA correctly to Superior. This is due to the misapplication of FAS 125 to the OC account beginning in 1995, the adoption of a more liberal discount assumption in 1999 (refer to Topics 2 and 4 for additional information), the misapplication of interagency classifications (refer to Topic 5 for additional information) and the excessive dividend payments based on gain on sale accounting beginning in 1993 (refer to topic 7 for additional information.) If these areas had been detected and corrected earlier, perhaps the capital ratios reflected in the OTS reports would have more validity. However, based on the OTS examination reports and the actual events that transpired at the institution, an accurate assessment of OTS's application of PCA cannot be determined for these years. However, beginning with the 2000 examination, we believe that the OTS did not apply the provisions of PCA appropriately.

At the conclusion of the January 2000 examination, the risk-based capital ratios on a pre- and post-tax basis were 7.81 and 8.57 percent. By using the post-tax capital ratio, Superior was classified as "adequately capitalized." If the OTS had elected to use the pre-tax capital ratios, Superior would have been "undercapitalized."

Superior's composite rating was nonetheless downgraded from a "2" to a composite "4," reflecting the sharp decline in the overall condition of the institution due primarily to the high-risk lending program and the inordinate concentration in residual interests and the unsupported assumptions used to value them.

According to the OTS legal counsel, the institution could have been reclassified under PCA provisions and treated as if it were in the next lower capital category, which would have been "undercapitalized" thus subjecting the institution to various constraints under PCA. Because of its deteriorating condition due to the excessive volume of concentrations in high-risk assets, the OTS would have had the leverage to implement corrective measures earlier. However, the OTS did not take any actions under the guidelines of PCA at that time.

The OTS and the FDIC conducted a visitation at Superior in October 2000. Although the emphasis of the visitation was not focused on the institution's PCA category, a schedule included at the end of the OTS visitation report indicates the capital levels at the conclusion of the visitation. After performing the calculations of the pre- and post-tax columns, the results reveal that Superior was "significantly undercapitalized." On a pre-tax basis, the risk-based capital ratio was 2.33 percent; on a post-tax basis, the risk-based capital ratio was 5.20 percent.

On February 14, 2001, the OTS issued a PCA Directive to Superior. This action was based on activities that occurred at the January 2000 examination and activities that were discovered at the October 2000 visitation, which were not resolved until January 2001. The resulting write-down in the OC account (refer to Topic 2 for additional details) of $270 million caused Superior to fall into the significantly undercapitalized PCA category as of December 31, 2000. During the March 2001 examination, the OTS did not require the write-down of the residual interests for an additional $150 million due to the overvaluation resulting from the use of liberal discount assumptions. The OTS did not require the write-down at this time because of the negotiations between Superior's owners and the regulators associated with a recapitalization plan.

The OTS is responsible for implementing and enforcing PCA regulations for the institutions that it supervises. The FDIC becomes involved only when an institution is considered critically undercapitalized, which is when the tangible equity capital ratio is equal to or less than 2 percent. Superior's tangible equity capital ratio hovered above the 2 percent threshold thereby precluding the FDIC from becoming involved since the institution was not yet considered critically undercapitalized.

By calculating the tax effect on loss classifications before calculating the capital ratios, the ratios can be inflated for PCA purposes. This is due to the reduced level of loss that is deducted from capital. For example, if losses total $10 million and a 39 percent tax rate is used, the resulting deduction from capital would be $6.1 million instead of the entire $10 million ($10,000,000 x .39 = $3,900,000. $10,000,000 - $3,900,000 = $6,100,000). By deducting the smaller $6.1 million value, the capital remains at a higher level, thereby increasing the resulting capital ratios. However, if the institution does not have sufficient income to realize a benefit from the tax effect, we believe that the calculation misrepresents the capital position. In fact, Superior was not making money and had no real income against which to offset the losses. Accordingly the "post-tax" rate was invalid and should not have been used. There was no evidence that the FDIC objected or approved of the post-tax calculation.

The OTS has not issued any specific guidelines stating whether the calculation of the pre- and post-tax capital ratios are a permissible activity or outlining particular circumstances when examiners may use discretion and recalculate the ratios by incorporating a tax effect for loss classifications. The Managing Director of Supervision of the OTS responded to an OIG request for information on this issue in a December 21, 2001 letter that stated that "applicable OTS law, regulations, policies, and financial reporting guidance clearly state that the agency follows generally accepted accounting principles (GAAP)," and that GAAP required "determining the impact of income taxes on regulatory capital." However, the Director did not indicate what process is used to determine if an institution can or will actually derive a benefit from the resulting tax effects. When the OTS was calculating the year-end 2000 capital ratios, a memo in the file from the OTS Chicago regional accountant indicated that since it was questionable whether or not Superior could realize the tax benefit immediately, a better indication of the capital ratios was reflected using the pre-tax ratios.

The OTS incorporated an effective tax rate of 39 percent on the loss classifications resulting in higher capital ratios and a higher PCA classification for Superior. When we confirmed how the OTS would calculate a tax rate in these circumstances, the OTS Chief Accountant stated that the application of an effective tax rate would not result in an accurate tax estimation for Superior due to its extremely complex structure. Since the capital ratios were higher by adjusting the capital deductions by applying a tax effect to the losses, Superior did not technically reach the critically undercapitalized category until July 24, 2001 when all loss classifications from the 2001 examination were deducted from capital as a result of the owners' refusal to implement the capital restoration plan. Based on Superior's insolvency, the institution was placed into receivership on July 27, 2001.

Office of Thrift Supervision Actions Impede Regulatory Process

Three of OTS's actions appear to have impeded the regulatory process. In particular, OTS did not always follow up on prior examination recommendations, did not allow FDIC's onsite participation in the January 25, 1999 safety and soundness examination, and calculated regulatory capital ratios on an after-tax basis. (Refer to Topics 5 and 9 for additional information.) Individually and collectively these actions served to limit effective actions from being implemented. In the July 6, 1993 ROE, OTS recommended that the bank develop a comprehensive dividend policy that considered the impact on capital from those assets (gains) created from the securitization and sale of loans. Had this recommendation been implemented by Superior and followed up on by OTS, Superior, potentially, would not have declared any dividends and would have had over $200 million more in capital. However, this recommendation was never repeated in subsequent reports. In addition, in the August 8, 1994, and September 11, 1995, ROEs, OTS criticized management for errors in Superior's capital calculations. However, corrective action was not implemented by the institution, nor did OTS formally follow up and reiterate these criticisms and recommendations in subsequent examination reports. The OTS re-identified and presented the errors again in the January 24, 2000 examination, along with further criticisms about management's ability to substantiate the allowance for loan and lease losses. While the lack of follow up on prior examinations appears to have been an oversight, the limits placed on the FDIC's participation in the examination process and the calculation of regulatory capital ratios using after-tax effects were intentional decisions by OTS.

Federal Deposit Insurance Corporation

The FDIC helped to identify weaknesses and problems within the institution during its onsite examinations and offsite monitoring processes. However, the FDIC's lack of direct regulatory authority limited the FDIC's actions. In particular, the FDIC first identified the bank's high-risk asset structure and increased its supervisory concern in September 1998. In December 1998, the FDIC formally requested to participate in OTS's 1999 safety and soundness examination. When OTS limited the FDIC participation in the 1999 onsite examination, the FDIC's Chicago Regional Office did not pursue the use of its special examination authority by presenting a board case to the

FDIC's Board of Directors to request access to the institution. Regardless, based on the results of the January 25, 1999 safety and soundness examination, the FDIC perceived a greater degree of risk than OTS and downgraded the bank's rating for risk related premium purposes. Subsequently, the FDIC participated in the last two examinations and provided review and consultative guidance to OTS. While the FDIC enhanced the supervisory review process, the FDIC did not identify and formally express concern over OTS's methodology of calculating the bank's regulatory capital ratios on an after-tax basis. As a result, the implementation of PCA was delayed.

Topic 7 - The regulators' monitoring of transactions between Superior and its holding company and affiliates, including the up-streaming of dividends.

The Office of Thrift Supervision (OTS) did not adequately monitor transactions between Superior and its holding companies and affiliates, even though OTS regulated both Superior and its holding companies. Consequently, transactions prohibited by the Federal Reserve Act were allowed to continue for more than 2 years, resulting in a $36.7 million loss to Superior as assets and cash were improperly transferred to Superior's affiliates and holding company. In addition, Superior's dividend payments had a detrimental effect on capital. Based on Superior's policy of limiting dividends to 50 percent of net income, Superior distributed more than $200 million in dividends to its holding company, $12.5 million of which was not reported on Superior's Thrift Financial Reports. OTS assessed the reasonableness of dividends based on the bank's recorded amount of net income; however, the OTS's analysis was flawed. In particular, a significant portion of the bank's net income was made up of imputed gains, which were unrealized and subject to significant market and economic volatility. OTS did not assess the reasonableness of dividends based on gains that were actually realized by the bank on a cash flow basis.

Monitoring Transactions

In regulating both Superior and its holding companies – Coast-To-Coast Financial Corporation (CCFC) and Superior Holdings, Inc. (SHI) – the Office of Thrift Supervision (OTS) was in a unique position to review transactions between them from two different perspectives. In fact, OTS Reports of Examination (ROE) for both the thrift and its holding companies discussed the review of transactions with affiliates and the payment of dividends. However, OTS performed four exams of Superior and its holding companies without discovering $36.7 million in transactions that were prohibited by the Federal Reserve Act.

Thrift Reports of Examination

Section 380 of OTS's Thrift Activities Regulatory Handbook, entitled "Transactions with Affiliates and Insiders," prescribes detailed and thorough procedures for OTS examiners. In fact, OTS reviewed transactions with affiliates and the payment of dividends as part of each full-scope examination performed for Superior. However, no criticism of transactions was noted until the March 2001 exam. That was Superior's last exam and was completed in July 2001 but not finalized before Superior was closed. In that report, OTS stated that Superior was in apparent violation of several regulations regarding transactions with affiliates and the transactions had been ongoing since April 1999. In total Superior was owed more than $36.7 million by CCFC and its affiliates as of March 31, 2001, as detailed in the following table.

Table 17: Superior's Unsecured Extensions of Credit to Affiliates

Company and Purpose of Credit from Superior	Amount (in thousands)
Coast-To-Coast Financial Corporation (CCFC)	
Market premium on Series 2000-3 securitization	$ 7,363
Market premium on Series 2000-4 securitization	10,796
Additional premium on 2000-4 for subsequent transfer	2,099
Premium on Sold Loans	**$ 20,258**
Accrued interest on Series 2000-3 securitization	3,010
Accrued interest on Series 2000-4 securitization	2,980
Accrued Interest on Sold Loans	**$ 5,990**
Interest paid to Merrill Lynch on securitization funding line	**5,230**
Total Advances to CCFC	**$ 31,478**
Alliance Funding Company of Nevada (AFCN)	
Non-recoverable servicer advances	**$ 4,945**
Coast-To-Coast Auto Dealer Corporation (CCADC)	**(656)**
Coast-To-Coast Leasing Corporation (CCLC)	
Marketing fees	**936**
Total Unsecured Extensions of Credit to Affiliates	**$ 36,703**

Source: Office of Thrift Supervision and Federal Deposit Insurance Corporation Reports of Examination.

The earliest of these transactions related to six REMICs[73] that had all been called and closed. Superior had made more than $4.9 million in advances on loans recognized as charge-offs. The advances were made on behalf of Alliance Funding Corporation of Nevada, Inc. (AFCN), a Superior affiliate that owned the residual interest of the REMIC trusts benefiting from the advances. As of April 30, 1999, AFCN had sold the underlying loans. However, Superior, as servicer, failed to collect the advances due from the trust. The resulting loss should have been absorbed by AFCN, and not Superior.

As of March 31, 2001, Superior transferred $4.9 million from nonrecoverable advances on the servicing division's books to accounts receivable on the corporate division's books. OTS reported that this transaction was considered an affiliate violation of 12 CFR §563.42. This rule requires that transactions with affiliates be on terms and under circumstances that are substantially the same, or at least as favorable to the savings association, as those prevailing at the time for comparable transactions with non-affiliated companies. The holding company subsequently agreed to reimburse Superior for the $4.9 million after the Capital Plan was implemented, and to pay interest on the unpaid balance. The Capital Plan was never implemented and reimbursement was not made.

An additional $31.4 million of the receivable related to loan sale activity in the second half of 2000. At that time Superior was incurring operating losses and had a composite CAMELS rating of "4." According to OTS's January 2000 ROE, Superior was only adequately capitalized at that time, and its capital level was insufficient for Superior's primary business activity as a nationwide subprime mortgage banker with residual assets and loan servicing assets that were approximately twice its tangible capital.

[73] Real Estate Mortgage Investment Conduit (REMIC) is a multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans and is explained further in the Glossary.

Further, on July 7, 2000, OTS notified Superior that pursuant to issuance of the January 24, 2000 ROE it was a problem association[74] as defined in Regulatory Bulletin 27a, and was in troubled condition[75] as defined under 12 CFR §563.555. As such, Superior was immediately subject to several restrictions on asset growth, compensation and other employment considerations. As a further result of the January 2000 examination, OTS also required a corrective program that included restricting any additional residual interest assets[76] from being added to Superior's balance sheet.

In compliance with the corrective plan, Superior stopped securitizing loans on June 30, 2000. Even so, Superior continued to originate subprime loans. Instead of securitizing the loans and retaining the residual assets, Superior sold the loans it originated to its holding company. CCFC then securitized the loans and retained the residual assets.

However, during the third and fourth quarters of 2000 Superior sold loans to CCFC at less than fair market value. CCFC quickly resold the loans at a higher price, resulting in more than $20.2 million in gains to CCFC. According to OTS, it appeared that CCFC benefited from terms and conditions that were not at arm's length and were to the detriment of Superior. Further, OTS concluded that Superior's sale of the loans to CCFC constituted a sale of assets to an affiliate at a price of less than fair market value.

According to OTS, this was an apparent violation of 12 CFR §563.42. This Section requires that transactions with affiliates be on terms and under circumstances that are substantially the same, or at least as favorable to the association, as those prevailing at the time for comparable transactions with non-affiliated companies. When CCFC recognized it had not properly accounted for the fair market value of the loans, it caused Superior to book a receivable of approximately $20.2 million. The receivable represented an extension of credit to CCFC from Superior. According to OTS, this extension of credit

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[74] In general, OTS Regulatory Bulletin 27a (RB 27a) defines a problem association as a savings association that: (1) has a composite rating of 4 or 5; (2) is undercapitalized under prompt corrective action standards; (3) is subject to a capital directive, cease and desist order, consent order, or formal written agreement relating to the safety and soundness or financial viability of the savings association; or (4) has been notified in writing by the OTS that it has been designated a problem association or an association in troubled condition.

[75] Under 12 CFR §563.555, troubled condition, in general, means: (1) a savings association that has a composite rating of 4 or 5; (2) a savings and loan holding company that has an unsatisfactory rating under OTS's holding company rating system, or that is informed in writing by the OTS that it has an adverse effect on its subsidiary savings association; (3) a savings association or savings and loan holding company that is subject to a capital directive, cease-and-desist order, consent order, formal written agreement, or prompt corrective action directive relating to the safety and soundness or financial viability of the savings association; or (4) a savings association or savings and loan holding company that is informed in writing by the OTS that it is in troubled condition based on information available to the OTS.

[76] The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

was an apparent violation of 12 CFR §563.41(c), which requires that extensions of credit to affiliates be collateralized. The transaction was also an apparent violation of 12 CFR §563.41(e), which requires savings associations to maintain adequate documentation of their transactions with affiliates.

The $36.7 million receivable also included approximately $5.2 million, incurred when CCFC obtained a warehouse funding line of credit from Merrill Lynch & Co. as part of the same loan sale. When that line was repaid, Merrill Lynch assessed CCFC approximately $5.2 million to cover additional interest expense on the funding line. Superior, on behalf of CCFC, advanced the $5.2 million.

Superior also booked as part of the receivable approximately $5.99 million to reflect an amount in accrued interest on the loans that were sold to CCFC that was owed to Superior as part of the loan sale. Lastly, the receivable included approximately $936,000 in marketing fees that were owed to Superior from CCFC.

In each of these transactions, Superior extended credit to its affiliates. According to OTS, these extensions of credit were in apparent violation of 12 CFR §563.41(c), which requires the collateralization of extensions of credit to an affiliate. The transactions also appeared to violate 12 CFR §563.41(e), which requires adequate documentation of transactions with affiliates. Moreover, it appears that these transactions also violated 12 CFR §563.42. This Section requires that transactions with affiliates be on terms and under circumstances that are substantially the same, or at least as favorable to the association, as those prevailing at the time for comparable transactions with non-affiliated companies.

Originally, the payment by CCFC of the receivable was to be accomplished through a transfer of the value of future cash flows from certain mortgage and auto loan residual interests owned by CCFC. These cash flows were valued at approximately $92.7 million by CCFC. OTS estimated that the present value of these assets was $81.0 million when they were transferred March 30, 2001. The portion of the cash flows not used to repay the referenced receivable was to be used as a contribution of capital to Superior.

According to OTS, the transfer of cash flows to repay the receivable owed to Superior from CCFC constituted a purchase of assets under the transactions with affiliates regulations and the fair market value of the cash flows was never adequately established. In addition, Merrill Lynch & Co. encumbered a large portion of the cash flows. OTS stated that this transaction was not adequately documented and was not on terms and under circumstances that are substantially the same, or at least as favorable to the association, as those prevailing at the time for comparable transactions with non-affiliated companies. Therefore, OTS concluded that the repayment transaction itself was an apparent violation of 12 CFR §563.41(e) and 12 CFR §563.42.

In April 2001 the OTS was notified that payment of the referenced receivable was being reversed and that the full amount of the value of the cash flows was being included as a capital infusion to Superior. This reversal was confirmed through OTS's review of

Superior's March 31, 2001 TFR that was filed on April 30, 2001. According to OTS, this resulted in Superior booking a receivable from CCFC totaling $36.7 million, which created the same transaction with affiliates violations noted before the transfer of the cash flows. Namely, it was a violation of 12 CFR §563.41(c), 12 CFR §563.41(e), and 12 CFR §563.42.

Furthermore, OTS noted that these extensions of credit and asset purchases also appeared to violate 12 CFR §563.41(a)(1)(i) and §563(a)(1)(ii). These Sections prohibit the aggregate amount of covered transactions with any affiliate from exceeding 10 percent of the capital and surplus of the savings association, and prohibit the aggregate amount of covered transactions with all affiliates from exceeding 20 percent of the capital and surplus of the savings association.

Between April 1999 when the prohibited transactions began and the March 2001 exam when the transactions were reported, OTS performed full-scope examinations of Superior, CCFC, and SHI in January 2000 and a visitation for Superior in October 2000. In our opinion, all four reviews should have disclosed the prohibited transactions. The OTS management official in charge of the examinations also stated that OTS examiners should have found the prohibited transactions during these exams.

The FDIC also participated in the January 2000, October 2000, and March 2001 reviews of Superior. However, according to the FDIC planning documents, the FDIC examiners focused on Capital, Assets, and Management – specifically, securitization activities, high-risk loan portfolio, and complex regulatory accounting and reporting issues. FDIC personnel stated they did not review transactions between Superior and its holding companies and affiliates, or payment of dividends.

Holding Company Reports of Examination

OTS also reviewed transactions with affiliates and dividend payments in every examination of Superior's holding companies, CCFC and SHI. OTS consistently gave the holding companies "Satisfactory" ratings, except in its May 2001 reports. However, the May 2001 reports were not finalized until after OTS closed Superior, and the reports were not forwarded to the holding companies. The apparent violations of Sections 23A and 23B of the Federal Reserve Act were not reported in the January 2000 holding company ROEs. Nonetheless, according to the OTS management official in charge of the examinations, the violations should have been found.

In the May 2001 reports, OTS gave the holding companies "Unsatisfactory" ratings because of the poor financial condition of the thrift. The apparent violations of law were mentioned in CCFC's report but not explained, and OTS simply noted that recovery of the funds was addressed in the Capital Plan. However, the Capital Plan was never completed, and the $36.7 million was not repaid before Superior failed.

Notwithstanding its Satisfactory ratings in earlier reports, OTS criticized CCFC in almost every holding company examination report for late filings of required regulatory reports;

specifically, quarterly and annual H-(b)11 reports. Section 10(b)(2) of the Home Owners' Loan Act (HOLA), as amended, 12 U.S.C. §1467a(b)(2), and 12 CFR §584.1(a)(2) require each savings and loan holding company (SLHC) to file Annual and Current Reports. An Annual Report on Form H-(b)11 must be filed not later than 90 days after the fiscal year end. Current Reports, providing quarterly updates of certain information, must also be filed under cover of Form H-(b)11. Current Reports must be filed within 45 days of the end of each quarter. However, in one instance – for March 31, 1993 – CCFC failed to file its quarterly report. In another instance, the annual H-(b)11 report for the fiscal year ended June 30, 1994 was filed 7 months late and did not include financial statements for the holding company.

Moreover, CCFC's financial statements for the fiscal year ended June 30, 1995, which were due by September 28, 1995, were not provided to the examination team until October 30, 1995. According to the holding company report of examination, the delayed receipt of those annual financial statements substantially delayed completion of examinations for both the thrift and the holding company.

In the 1995 holding company report of examination, OTS notified holding company management that civil money penalties may be assessed because of continued late and incomplete filing of required reports. In 1996 the holding company was again criticized because regulatory reports lacked current financial information, but no penalties were assessed. In fact, no civil money penalties were ever assessed. Furthermore, from 1993 through 1995 Superior failed to report the payment of approximately $12.5 million in non-cash dividends in its Thrift Financial Reports, as required. Although the payments of these dividends is discussed in holding company reports of examination, OTS never addressed Superior's failure to report them.

For more than 2 years OTS did not find transactions prohibited by the Federal Reserve Act. In addition, OTS did not properly address CCFC's late filings and failure to file required financial reports or its failure to report all dividends paid. As a result, Superior did not report more than $12.5 million of dividends in its Thrift Financial Reports. Further, Superior made extensions of credit to its holding company and affiliates totaling $36.7 million, in apparent violation of federal law.

Dividend Payments

Although Superior's payment of dividends to its holding companies was within federal guidelines at the time they were made, dividends paid were excessive. OTS approved Superior's requests to pay dividends without performing a thorough review and analysis of earnings. Furthermore, as a result of an accounting error and liberal assumptions used in valuing the residual interests and OC accounts, the bank's assets and capital were overstated. Concomitantly, earnings were overstated as a result of this valuation. Had these accounts been properly valued, dividend payments would have been substantially reduced or possibly even eliminated.

Superior made application to OTS for the payment of each dividend in accordance with 12 CFR. §563.134. OTS reviewed each request and did not object to the payment of any dividend. Amounts paid by Superior as dividends are shown in the following tables.

Table 18: Dividends Made by Superior Through June 30, 2001 (shown as a percentage of calendar year net income after taxes)

Calendar Year	Dividends Paid (in thousands)	Net Income (in thousands)	Percent of Net Income Paid Out
1988	$ 0	$ (19,901)	n/a
1989	0	3,276	0
1990	0	8,423	0
1991	0	(1,887)	n/a
1992	2,147	2,795	76.8%
1993	19,773 [1]	20,673	95.6%
1994	5,793 [1]	10,791	53.7%
1995	11,655 [1]	28,471	40.9%
1996	35,291	78,954	44.7%
1997	36,556	73,870	49.5%
1998	56,022	109,979	50.9%
1999	33,556 [2]	104,887	32.0%
2000	0	(5,638)	n/a
2001 [4]	0	(100,811) [3]	n/a
Total	**$ 200,793 [4]**	**$ 313,882**	**75.7%**

Source: Office of Thrift Supervision TFRs, Reports of Examination, and internal documents.

[1]Includes more than $12.5 million in non-cash dividends – financial receivables – that were not reported in Superior's TFRs: $12,018,000 in 1993, $87,000 in 1994, and $471,000 in 1995. Only cash dividends were reported in the TFRs: $7,755,000 in 1993, $5,706,000 in 1994, and $11,184,000 in 1995.

[2]Includes cash totaling $15,000,000 and financial receivables totaling $18,556,000, all of which were reported in the TFRs.

[3]January 2001 through June 2001 only. Any net income or loss from July 2001, before Superior was closed, is not included.

[4] Superior reported the payment of $188,217,000 in dividends in its TFRs. Actual payments totaled $200,793,000: cash of $169,661,000; and financial receivables of $31,132,000.

Table 19: Cumulative dividends made by Superior through June 30, 2001 (shown as a percentage of cumulative net income after taxes)

Calendar Year	Cumulative Dividends Paid (in thousands)	Cumulative Net Income (in thousands)	Cumulative Percentage of Net Income Paid Out
1988	$ 0	$ (19,901)	0
1989	0	(16,625)	0
1990	0	(8,202)	0
1991	0	(10,089)	0
1992	2,147	(7,294)	n/a
1993	21,920	13,379	163.8%
1994	27,713	24,170	114.7%
1995	39,368	52,641	74.8%
1996	74,659	131,595	56.7%
1997	111,215	205,465	54.1%
1998	167,237	315,444	53.0%
1999	200,793	420,331	47.8%
2000	200,793	414,693	57.3%
2001 [1]	$ 200,796	$ 313,882 [1]	75.7%

Source: Office of Thrift Supervision (OTS) Thrift Financial Reports, Reports of Examination, and internal documents.

[1] January 2001 through June 2001only. Any net income or loss from July 2001, before Superior was closed, is not included.

Before 1999 OTS reviewed Superior's applications to pay dividends using the criteria contained in 12 CFR §563.134. Under those rules, tier 1 associations[77] like Superior were allowed to make capital distributions of up to the greater of (1) 100 percent of net income for the calendar year plus one-half of surplus capital calculated at the beginning of the calendar year or (2) 75 percent of net income for the most recent four quarter period. In 1999 those rules were superceded by new rules contained in 12 CFR §563.143. Generally, under the new rules OTS determines whether the payment of dividends (a) will cause the institution to become undercapitalized; (b) raises safety and soundness concerns; or (c) violates any statute, regulation, or agreement. OTS also made other evaluations of the thrift's condition.

In addition, Superior's internal dividend policy limited cash payments to the holding company to 50 percent of quarterly net income. However, Superior requested and received approval from the OTS to exceed this policy during 1993 and 1994. For example, according to the holding company report of examination for the fiscal year ended June 30, 1994, the holding company received dividends from Superior totaling slightly more than $20 million. That amount represented 146.4 percent of Superior's $13.7 million net income for the fiscal year. The dividends consisted of $7.9 million in cash, $11.8 million of R-Class securities (excess mortgage servicing rights), and

[77] Under 12 CFR §563.134(a)(8), a tier 1 association was a savings association that had capital equal to or greater than the amount of its capital requirement immediately prior to, and on a *pro forma* basis after giving effect to, a proposed capital distribution.

$257,000 of B-Class securities.[78] In its report, OTS stated that the use of assets in the dividend payment would reduce Superior's overall level of risk and was approved by the OTS as an acceptable method of reducing the "higher risk" excess mortgage servicing rights on Superior's books. However, because of losses sustained by Superior in earlier years, that amount also represented 116 percent of Superior's total net income since inception.

OTS's holding company reports of examination and examinations of Superior also discussed Superior's payment of dividends. The reports typically stated that payment of dividends by Superior did not have an adverse effect on its compliance with capital regulations as the institution was generally classified as "Well Capitalized." Although OTS approved Superior's dividend requests as being in compliance with applicable regulations, OTS did so before it concluded that Superior's residual interests were overvalued and before the OTS performed a thorough analysis and assessment of the potential impact of imputed gains on earnings and to the institution. Because Superior's residual assets were overvalued, Superior's earnings and capital were overstated, which would have affected OTS's review and approval of Superior's dividend payments.

In addition, as explained earlier, Superior made uncollateralized extensions of credit to its holding company and affiliates totaling $36.7 million in apparent violation of federal law, and this receivable was not repaid before Superior closed. The majority of this receivable accumulated in the third and fourth quarters of 2000 when Superior sold loans to CCFC at less than fair market value. At that time, Superior was significantly undercapitalized according to a recalculation done by OTS in Superior's March 2001 report of examination. Superior was also incurring operating losses at that time and had a composite CAMELS rating of "4." As such, it would not have been allowed to pay dividends had application been made.

Furthermore, according to OTS's March 2001 report of examination, Superior's effective earnings for the past several years were substantially less than the results reported by management on regulatory reports. Superior's earnings were also less than the results reported on the annual statements audited and verified by E&Y, the outside accounting firm. According to OTS, inflated gains on loan sales masked the true earning capability of Superior under its principal lines of business. Inefficiencies of the loan origination platform became apparent when gain on sale accounting ceased. In addition, unproductive business endeavors could no longer be supported and Superior's complicated accounting system with numerous divisions and operating units also contributed to the operational problems.

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[78] At various times, Superior issued Class A, B, R, and S securities as part of its securitization transactions. Class A and Class B certificates consisted of interest bearing principal REMIC securities (REMICs are explained further in the Glossary) while the Class R and Class S certificates were interest-only REMIC securities.

OTS unknowingly allowed Superior to pay excessive dividends and to potentially cause the depletion of its capital because OTS did not thoroughly analyze and assess the bank's earnings performance as it was affected by imputed gains, and OTS did not determine that Superior's residual interests and overcollateralization accounts were overvalued until October 2000. The exact amount of excessive dividends cannot be quantified because the overvaluation of the residual interests and overcollateralization accounts affected all prior periods. In addition, Superior made non-cash dividends in the form of financial receivables that cannot be properly valued until sold.

Topic 8 - The regulators' efforts to detect the potential for bank fraud and insider abuse at Superior Bank.

The regulators did not always scrutinize "red flags" that existed at Superior. Several warning signs were clearly evident as early as 1994 that should have resulted in further investigation by the examiners. Perhaps the biggest warning sign of all was in 1996 when the bank had a Return on Assets of 7.56 percent which, at the time, was over 12 times more than that of the average thrift in the United States. Virtually all of Superior's earnings were derived from gain on sale accounting related to securitizing subprime mortgages. While at times it appears the Office of Thrift Supervision (OTS) reviewed some of the red flags, many red flags were not fully reviewed by the OTS.

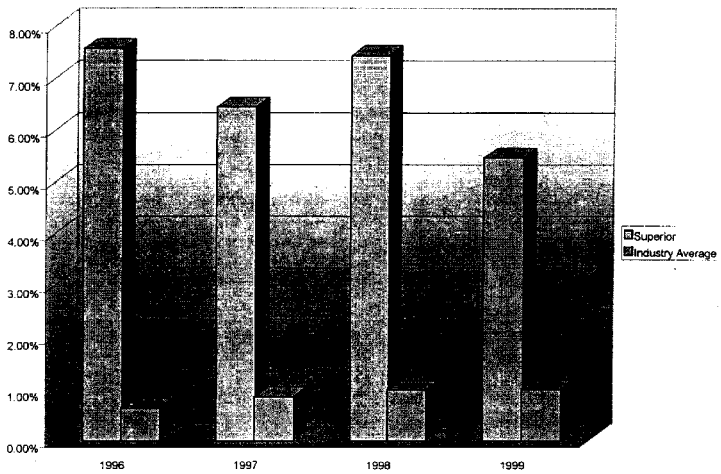
Detection of Insider Abuse and Fraud

The early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the Federal Deposit Insurance Corporation's (FDIC) deposit insurance funds and uninsured depositors. Although it is not possible to detect all instances of apparent fraud and insider abuse, potential problems can often be uncovered when certain warning signs are evident. It is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity. We recognize that a number of factors make it difficult to measure the effects of fraud and insider abuse. Oftentimes the line between poor business judgment and fraud and abuse is difficult to draw. Nevertheless, based on our review of the failure of Superior Bank it appears that some of the decisions made by Superior management rise to the level of insider abuse.

Extraordinarily High Return on Assets

Superior had the highest Return on Assets (ROA) of any thrift in the United States for 1996. Superior's ROA was 7.56 percent in 1996 when the average ROA for all insured Thrifts in the U.S. for 1996 was .62 percent. This trend continued until the year 2000. ROA is net income (including gains or losses on securities and extraordinary items) as a percentage of average total assets. It is the basic yardstick of bank profitability. Refer to Figure 3 for a comparison of Superior's ROA to the industry average ROA.

Figure 3: Superior's ROA Compared to the Industry Average ROA from 1996 – 1999



Source: Superior TFR reports and OTS Thrift Industry Data Report

While ordinarily an institution with a high ROA would not be cause for regulatory concern, most of Superior's net income resulted from gain on sale accounting. Superior would generate massive amounts of subprime mortgages, securitize the loans, and then sell the security and take back an interest-only strip receivable and other residual interests. It would then book a gain on sale for the transaction. As table 20 indicates, Superior lost money every year from 1995 on before giving consideration to its gain on sale income from securitizations.

Table 20: Effect of Gain on Sale Accounting on Net Income

Calendar Year	Net operating income (000's)	Gain on Sale Income (000's)	Net Income (000's)
1994	$3,562	$7,353	$10,791
1995	(1,075)	30,967	28,471
1996	(4,692)	64,727	78,954
1997	(17,813)	91,314	73,870
1998	(23,868)	137,103	109,979
1999	(26,613)	185,979	104,887
2000	(54,621)	43,372	(5,638)

Source: Superior's TFRs

To exacerbate the problem, the bank had a very large percentage of its assets in these risky and complex investments. These factors combined should have resulted in greater regulatory oversight; however, it appears the Office of Thrift Supervision did not scrutinize these transactions very much, apparently relying on verbal assurances from bank management and the opinion of the bank's external auditor, Ernst and Young.

Concentration in Residual Interests

Superior began booking residual interests in 1993 and by June 30, 1995 its residual assets[79] had reached 100.1 percent of core capital. The September 11, 1995 examination report noted "the thrift recorded $65.8 million of residuals, which represented 100.1 percent of capital."

The October 7, 1996 examination report, in the concentration section, noted that

> *The thrift's major business continues to be mortgage banking. The AFC [Alliance Funding Corporation] division originates, securitizes the loans into REMICS, and sells all of the collateral classes. The thrift retains the servicing on all loans sold and the residual interest-only classes of the REMIC securities. At June 30, 1996, these residuals totaled $148.2 million, which represented 142.0 percent of core capital. Despite continued originations and sales, the business plan shows that by June 1997, the balance of the residual interest classes will total $198.3 million, or 148.9 percent of core capital. The amortization of the earlier residuals, the increasing level of capital, and management's plan to keep risk-based capital above 10 percent are all factors that naturally suppress this concentration from dramatically rising.*

Moreover, the 1997 examination report noted the following:

> *The thrift's major business continues to be secondary marketing of mortgage and consumer loans. The servicing and excess interest residual classes of the REMIC and auto loan sales are retained and their imputed value is determined and recorded as assets. As of September 30, 1997, these assets totaled $225.2 million, which represented 19 percent of total assets and 147.4 percent of tangible capital. The continued amortization of the assets, the increasing level of capital and management's plan to maintain at least 10 percent in risk-based capital mitigates the concern regarding this concentration.*

The FDIC Examination Manual defines a concentration as a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These risks may in the aggregate present a substantial risk to

[79] The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

the safety and soundness of the institution. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. Where reasonable diversification realistically cannot be achieved, the resultant concentration calls for capital levels higher than the regulatory minimums.

The OTS Regulatory Handbook defines a concentration as a significantly large volume of assets that a thrift has advanced or committed to an individual or group of borrowers related by a common dependency or a common risk characteristic. Assets with a common dependency should be recognized as a concentration if they exceed 25 percent of core capital and general valuation allowances. All concentrations are not inherently objectionable, if they are properly controlled through underwriting standards. Thrift management should identify concentrations and assess their size and individual risk so policies and plans can be adjusted accordingly. At a minimum, management should identify, measure, monitor and regularly report significant concentrations to the Board of Directors to provide a basis for board policy.

Regulators should monitor concentrations and conduct a more in-depth periodic review of them than of diversified areas of the loan portfolio. Regulators should evaluate management's control of concentrations and use of diversification to limit or prevent excessive risk of loss. For unavoidable concentrations, strict underwriting standards should be followed to limit credit risk.

A review of OTS examination reports shows that although concentrations were frequently noted by examiners, there was no discussion of what bank management was doing to mitigate the risk that came with the concentrations. Nor was there any discussion of how underwriting standards were being used to control risk. We reviewed Superior's Board of Director minutes from 1995 to 1998 and did not see any discussion at the board level as to the risk these concentrations posed to the bank.

Capital was Not Commensurate with Risk

Although Superior's niche was in risky subprime lending and securitizations beginning in 1993, it was never required by OTS to increase capital commensurate with that risk until 2001. Superior's capital averaged about 11 percent from 1995 to 1999 when the average equity ratio of non-bank subprime lenders was typically over 20 percent. Superior's capital met regulatory guidelines but it fell far short of what the market generally required.

Filing of Inaccurate Thrift Financial Reports (TFR)

As early as 1996, Superior submitted TFRs that were inaccurate. For example, the September 30, 1997 TFR reported classified assets of $5.7 million, or 2.9 percent of tangible capital. The reported classified assets consisted primarily of delinquent loans on single family residences. Management did not classify automobile loans delinquent 90 to 119 days totaling over $4 million and repossessed automobiles and REO properties totaling over $1.3 million. OTS examiners had to revise classified assets to $11.3 million

or 5.8 percent of tangible capital. Bank management agreed that these assets should have been classified and stated that future supervisory reports would be accurate.

The January 1999 Examination report noted that classified assets were substantially understated on the December 31, 1998 TFR. Also, the report noted that the TFRs filed for the previous quarters of 1998 understated the level of classified assets. At December 31, 1998, Superior reported classified assets of $32.3 million or 13.1 percent of tangible capital plus allowable allowance for loan and lease losses. During the 1999 examination, OTS revised the classification totals for December 31, 1998 to $64.7 million, over twice what the bank had reported on its TFR.

In addition, Superior frequently showed a difference between its TFRs and financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP), especially relating to the financial receivables and reserve accounts. Since TFR instructions indicate these items should be shown in accordance with GAAP, there would be no reason for these reporting differences (Refer to Topic 3 for a discussion of TFR errors.) Also, lax charge-off procedures related to auto loans were noted at the bank. The bank was reporting auto loss classifications on internal reports but not reflecting the losses on regulatory reports.

The Internal Audit Process Was Limited

According to the Director of Internal Audit, audit committee meetings were very infrequent, and bank management did not address numerous audit items. Moreover, the operations at Superior-affiliate Fintek, whose President was also Superior's Chairman, were considered "off-limits" to the internal audit department even though the affiliate calculated the value for residual interests in addition to providing vital investment, liquidity, and overall financial advisory services to Superior.

One of the primary objectives of the OTS's March 2001 examination was to determine if the residual assets were being properly valued, after the October 16, 2000 field visitation disclosed that the institution's external auditors, Ernst & Young (E&Y), did not appropriately advise Superior how to account for a portion of the residual assets in accordance with GAAP. A recalculation of the OC account, one of the components of the residual assets, resulted in a mandatory write-down of $270 million as of December 31, 2000. On March 2, 2001, Superior amended its December 31, 2000 Call Report to reflect a more accurate value of the OC account. The amendment caused the institution to be downgraded from "adequately capitalized" to "significantly undercapitalized." At the conclusion of the March 2001 OTS examination, an additional $150 million write-down was needed to accurately reflect the value of the residual interests. Had the internal audit department been free to review Fintek operations, the inadequate support for the valuation assumptions used might have been detected earlier.

Questionable Management Practices

Questionable management practices were evident at Superior for many years. Although examiners eventually detected most of the problems, it appears that prior to the year 2000, OTS did not sufficiently follow up on the warning signs.

In 1996, the holding company CCFC made a $70 million loan to UBH, Inc., one of the holding companies that owned Coast-to-Coast Financial Corporation. According to the promissory note dated March 29, 1996, partial interest payments were to be made monthly through July 1997. The remainder of the interest and all of the principal was to be paid in one installment on December 31, 1999. We could not find any evidence that any payments were made on this loan. OTS officials also questioned whether UBH, Inc. ever made any payments to the holding company for this loan. This money could have been made available to Superior when its capital levels fell shortly after the loan payment was due. Since the terms and conditions of the loan are somewhat vague and no loan payments were apparently made, it raises the question whether this was actually a dividend payment rather than a loan.

An example of questionable management practices was illustrated during the January 2000 examination. OTS examiners found a $12 million discrepancy in problem assets reported by the bank as of December 31, 1999. Upon investigation by the examiners, it was discovered that the $12 million in problem assets had in fact been sold to an advertising agency. Basically the bank had swapped $12 million worth of repossessed autos and liquidated deficiencies for credits on future advertising placed with an advertising agency. To obtain the credits, Superior would have to spend $67.3 million within 4 years at prices determined by the advertising agency. No previous advertising had been placed with this advertising agency. The OTS Regional Accountant determined that the transaction had little or no value and Superior had actually received assets that were inferior to those that were traded. Consequently, OTS required the bank to charge-off the entire $12 million in future advertising credits.

Another example of a questionable practice was identified by OTS examiners during the March 2001 examination. The examiners uncovered a series of transactions involving the bank and its holding company where the holding company appeared to benefit from terms and conditions that were not at arm's length and that were detrimental to the bank. These transactions totaled almost $37 million and violated various statutes and regulations. For example, examiners discovered that during the fourth calendar quarter of 2000 Superior sold loans at a fixed price to CCFC. CCFC then quickly resold the loans and reaped over a $20 million gain on the transaction. This transaction violated various federal regulations by selling assets to an affiliate at a price less than fair market value.

Section 360 of the OTS Regulatory Handbook, Thrift Activities, identifies certain red flags that examiners should be looking for and notes that appropriate measures should be taken to follow up. It appears that examiners may have relied too much on bank management assertions, representations from the bank's external auditors, and the reported wealth of the owners of the holding company. According to the

January 2000 examination report, failure was not considered likely due to the overall strength, financial capacity, and support of the ownership interests.

It does not appear that OTS performed an extensive analysis of the model used by the bank in determining the carrying value of the residual interests. Assumptions used by the bank appear to have been accepted without comparison to other banks and entities in the same line of business. A solid internal control structure and risk management program was not in place at Superior.

As a result, the bank had grossly inflated earnings from 1996 through 1999. The owners received over $200 million in dividends during the 1990s, most of which occurred between 1995 and 1999. When OTS was not critical of the bank during the earlier examinations, it may have contributed to the bank's unbridled growth into subprime lending and securitizations.

Topic 9 - Any issues regarding the lack of coordination or communication between the OTS and the FDIC and between the OTS' regional and home offices.

Our analysis determined that the most critical issue regarding the lack of coordination and communication between the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC) occurred when OTS denied the FDIC's on-site participation in the January 1999 OTS safety and soundness examination. The FDIC's request to have one examiner onsite was denied by the OTS; however, the FDIC ultimately agreed to a less satisfactory arrangement of meeting OTS examiners off-site during the examination. Although the FDIC has special examination authority under section 10(b)(3) of the Federal Deposit Insurance Act to make any special examination of any insured depository institution for insurance purposes, there are required procedures that can inhibit timely and justified access. If the FDIC had participated in the examination, the two regulators working together may have been more effective in minimizing the losses to the Savings Association Insurance Fund.

FDIC Requests To Participate in OTS Safety and Soundness Examination

In December 1998, a Division of Supervision case manager from the Federal Deposit Insurance Corporation's (FDIC) Chicago Regional Office (DOS case manager) concurrently conducted the quarterly (9/30/98) Billion Dollar Insured Deposit Institution (BIDI) off-site review and a review of audited financial statements for Superior Bank. The DOS case manager observed that Superior Bank exhibited a high-risk asset structure. He observed significant investments in the residual values of the securitizations of loans that exhibited interest rates substantially higher than peer institutions. He stated that although Superior Bank had not been identified as a subprime lender in the past, the high interest rates were characteristic of such portfolios. He also observed that Superior's June 30, 1998 Thrift Financial Report reflected Allowance for Loans and Lease Losses amounts that were about twice the amounts that could be determined from the audited financial statements.

The DOS case manager contacted the Office of Thrift Supervision (OTS) Central Regional Office field manager (OTS field manager) responsible for Superior Bank to discuss his observations and concerns. According to the DOS case manager, despite Superior's unusual operational characteristics, the OTS field manger had no significant concerns, in part because Superior management was well regarded by OTS. Based upon the DOS case manager's belief that the concentration in subprime lending warranted closer supervision, he recommended that the FDIC participate in the OTS's next safety and soundness examination of Superior Bank which was scheduled to start in January 1999.

The FDIC's special examination authority is contained in subsection 10(b)(3) of the Federal Deposit Insurance Act, 12 USC §1820(b)(3). The law provides the FDIC Board of Directors with the power to authorize special examinations of any insured depository institution to determine its condition for insurance purposes. On March 9, 1995, the FDIC Board of Directors delegated authority to the FDIC Director of DOS to conduct examinations, visitations, and/or other examination activities for insurance purposes as follows:

1) Examinations, visitations or similar activities when the primary federal regulator has invited FDIC participation;
2) Examination activities associated with CAMEL 4 and 5 rated institutions or situations of potential or likely failure of an institution within a 1-year time frame when the primary federal regulator does not object to the FDIC's participation; and
3) Examination activities where there are material deteriorating conditions not reflected in the current CAMEL rating and the primary federal regulator does not object to FDIC participation.

The foregoing authority is subject to meeting the following standards:

1) Potential or likely failure of an institution within a 1-year time frame, or
2) Reasonable basis for believing that an institution represents a greater than normal risk to the insurance fund and data available from other sources is insufficient to assess that risk.

All other requests are required to be presented to the FDIC Board of Directors for decision.

Based upon the FDIC Board's delegated authority, the FDIC appropriately established a reasonable basis of identifying risk to the insurance fund and acted within its authority to request participation in the OTS's next scheduled safety and soundness examination. However, the FDIC had to seek approval from the OTS to participate in an examination.

OTS Denies FDIC's Participation in the January 1999 Examination

The DOS case manager responsible for monitoring Superior Bank contacted the OTS field manager on December 22, 1998 to ask if one FDIC examiner could participate in the next OTS examination scheduled during January 1999. The OTS field manager responded that the FDIC would have to make a formal written request to the OTS Central Regional Office Regional Director (OTS Regional Director). A formal written request dated December 28, 1998 was addressed to the OTS Regional Director from the FDIC DOS Chicago Region Regional Director (DOS Regional Director).

The OTS regional office officials had concerns with the FDIC's request to participate in the January 1999 safety and soundness examination. The OTS field manager did not think it would be a good idea because Superior Bank had a lawsuit[80] in process against the FDIC. In an e-mail sent to the OTS Central Regional Office Regional Deputy Director (OTS Regional Deputy Director) notifying him of the FDIC's oral request and forthcoming written request, the OTS field manager stated that,

> *Superior has always been very cooperative with OTS and I wouldn't want to jeopardize our working relationship with Superior. I know that Superior's management has a poor opinion of the FDIC and I think that Superior would be very upset if the FDIC were to come in with us.*

The OTS Regional Deputy Director forwarded the field manager's e-mail to the OTS Regional Director and added the following comments,

> *While I feel [Superior Bank] management here at the local level is far enough removed from the litigation with the FDIC. [Superior Bank's Chairman of the Board] is not. However, if the FDIC is interested in the capital markets area, [Superior Bank's Chairman of the Board] is likely to be very involved in the capital market discussions. Bottom line is the FDIC still needs to convey a good reason for why they want to join us. We'll just have to wait and see.*

It appears that a miscommunication involving the issuance and receipt of the formal written request by the DOS Regional Director to the OTS's Regional Director compounded the back-up examination access issue with a critical delay. According to OTS management officials interviewed during our review, they never saw the written request from the FDIC and only learned of the existence of the written letter after Superior failed in July 2001.

Because the FDIC had not received a response from OTS, the DOS Regional Director telephoned the OTS Regional Director on Friday, January 15, 1999 just 4 days prior to when the FDIC believed the OTS examination of Superior Bank was to commence. According to the DOS Regional Director, during this telephone call, the OTS Regional Director verbally denied the FDIC's request to join the OTS examination. The reason given to the DOS Regional Director was that Superior Bank had been rated a CAMEL composite "1"[81] at its last examination in 1997 and it was not the regular practice of the

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[80] There were unresolved issues between the bank and the FDIC related to the interpretation and administration of the Federal Savings and Loan Insurance Corporation (FSLIC) Assistance Agreement, including such items as the carrying amount of covered assets, timing of certain payments and reimbursements of certain expenses. The bank intended to pursue recovery from the FDIC.

[81] CAMEL Composite "1" rating -Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

FDIC to participate in OTS examinations of thrifts with such ratings. The OTS Regional Director said that to his knowledge, the FDIC had not previously requested to participate in any examination of an institution rated a CAMEL composite "1" or "2." In addition, OTS raised concerns over possible negative perceptions that an on-site FDIC presence might cause due to the litigation between Superior Bank and the FDIC.

According to FDIC officials, OTS never discussed the intent of the FDIC's request during the telephone conversation. The OTS Regional Director did propose an off-site meeting between the OTS examiners and the FDIC Regional Capital Markets Specialist. According to Chicago DOS officials, they were not in favor of the proposed arrangement, but given that the examination was to start the following week, they accepted the offer.

Although OTS acted in accordance with established guidelines in denying the FDIC's request to participate in the 1999 examination, it does not appear that OTS had justifiable reasons for its decision. The OTS Central Regional Office officials raised their concerns regarding the ongoing litigation between the FDIC and Superior Bank. The litigation involving the assistance agreement originally made between the Federal Savings and Loan Insurance Corporation and Superior Bank was related to the FDIC's Division of Resolutions and Receiverships and not the FDIC's Division of Supervision. We asked OTS management officials if they had consulted with OTS Office of General Counsel to determine if there was a potential conflict of interest. They responded that they had not asked for legal input.

In an interview with the OTS field manager, he explained that Superior's management was concerned about the lawsuit and that they were "paranoid" about what OTS was sharing with the FDIC. The OTS Regional Director told us that the bank's employees were afraid that the FDIC wanted to obtain information regarding the litigation rather than examination information. He added that there "may have been more animosity had the FDIC been on-site."

Based upon their actions, it appears that OTS regional office officials either felt that the FDIC did not have a reasonable basis for believing Superior Bank represented a greater than normal risk to the insurance fund or that the litigation issues outweighed the FDIC's concerns.

Access Issues Were Not Elevated to FDIC and OTS Headquarters

OTS issued a Regional Directors Memorandum on April 5, 1995 entitled *FDIC Participation on Examinations*. The memorandum requires that all FDIC requests to participate in OTS examinations be submitted to the OTS Regional Directors in writing. It also states that if the OTS Regional Director does not concur with the request, copies of all relevant correspondence should be forwarded to the OTS Director of Supervision in Washington, D.C. The OTS Director of Supervision will review the request and if the OTS Director concurs with the decision to deny the request, the OTS Director will notify the FDIC Director of Supervision of OTS's position so that the FDIC can move it forward to the FDIC board for resolution. OTS management officials claim to have

never seen the FDIC's written request, so it can be argued that there was no written request to advance to Washington, D.C.

In accordance with the FDIC Board of Directors' delegated authority, if the primary regulator objects to the FDIC's back-up examination request, the FDIC's alternative is to present a formal case to the FDIC's Board of Directors. When the OTS Regional Director refused the FDIC's request on January 15, 1999, the DOS Regional Director's understanding was that the examination was going to commence on the following business workday.

We asked the DOS regional officials why they did not raise the issue to Washington. The Regional Director's response was that it would have been too late, as it would have taken a Board resolution, and that would have taken too much time under the circumstances. He added that it would have been difficult, without having more detailed information, to present a solid case to the Board that the FDIC needed on-site access to a "1" rated institution as well as the fact that independent bond rating agencies had given Superior high ratings.

Regardless of whether a formal written request was sent or received, both the FDIC and OTS regional management officials were aware of each other's concerns and should have elevated the issues to their respective headquarters offices in Washington, D.C. It is possible that the access issues could have been resolved without presenting a formal request to the FDIC's Board of Directors.

Impact on Losses to the Insurance Fund

The FDIC was unable to thoroughly and effectively evaluate the risks inherent in the Bank's securitizations of subprime mortgage loans in early 1999. Subsequently, the institution dramatically expanded its portfolio of high-risk residuals that eventually contributed to the high losses incurred at the time of failure.

In her October 2001 testimony to the Senate Committee on Banking, Housing, and Urban Affairs (Senate Banking Committee), the OTS Director softened the 1999 examination denial by stating,

> *...it is important to recognize what happened next, which is...they reached an agreement that the OTS would pass on all its exam work papers and make available to the FDIC all of its examiners before the exam ended as a conduit to bring anything back that the FDIC wanted to have brought back.*

In our discussions with the FDIC examiners, we were told that OTS delayed the agreed upon meeting twice and that the meeting did not take place until the last week of the examination. The FDIC examiners said that they did not get sufficient information and/or answers to their questions from the OTS examiners. They added that even though OTS examiners reviewed some of the same areas that the FDIC examiners would have reviewed at the examination, they do not conduct their review in the same manner as the

FDIC examiners. For example, the OTS examiners reviewed the asset valuation account; however, according to DOS examiners, it was not reviewed at the same depth in which the FDIC examiners would have conducted the review. Even at the January 2000 examination of Superior Bank in which the FDIC participated, OTS did not review the valuation account in any great detail. The FDIC examiners told us that after their discussions with the OTS examiners, they felt more than ever that they needed to gain on-site access.

As a result of the 1999 safety and soundness examination of Superior Bank, the OTS downgraded the thrift to a CAMEL Composite "2." According to the OTS Regional Deputy Director, the reasons the rating was lowered included interest rate concerns, the slipping of asset quality in the auto lending program, and the earnings retention based primarily on gain of sale accounting. The FDIC case manager believed the rating was at best a "3" and probably a "4." However, the FDIC did not have sufficient information to justify a downgrade to a "4."

While it is not feasible for us to quantify in dollars whether or how much of the losses in high-risk residuals could have been prevented had the FDIC participated in the 1999 OTS examination of Superior Bank, there are certain facts that are clear:

- The FDIC was denied on-site access to participate in OTS's January 1999 examination of Superior. The OTS rated the thrift a "2" and the FDIC rated the thrift a "3."
- The FDIC was subsequently permitted to participate in OTS's January 2000 examination. (The OTS initially rated the thrift a "3," and the FDIC rated the thrift a "4." OTS subsequently lowered its rating to a "4.")
- Superior stopped creating residual interests (at the thrift level) less than 6 months following the 2000 examination in which the FDIC participated.
- Superior booked $272.2 million in residual interests between June 30, 1999 and June 30, 2000 (starting six months after the January 1999 examination).

The FDIC's capital markets specialist instrumental in identifying the residual interest valuation issues, was planning to participate in the 1999 examination and ultimately participated in the 2000 examination. He believes that he would have had the same questions in 1999 as he did after the 2000 examination. He also believes that he would have pursued answers in the same manner and perhaps reached the same conclusions. It is apparent that the FDIC's eventual participation had an impact on the federal regulatory oversight of Superior Bank and that the impact could have been more beneficial with earlier on-site access.

In his October 2001 testimony to the Senate Banking Committee, the FDIC Director, made the following observations:

> *...two sets of eyes, earlier in the process, might have mitigated a portion of the loss to the insurance funds. In part, this [access issue] is a shortcoming of the FDIC Board's own internal procedures. We intend to review, in fact we are reviewing whether our own Board's special insurance examination policy is inhibiting our ability to determine the risks which non-FDIC supervised institutions pose to our funds.*

Special Examination Authority Procedures Can Inhibit Timely and Justified Access

In our October 19, 1999 Audit Memorandum to the Chairman – *Results of OIG Review of the Backup Examination Process and DOS's Efforts to Monitor Megabank Insurance Risks*, we suggested that the FDIC Chairman request delegated authority from the FDIC Board to initiate special examinations without having to secure the concurrence of the primary federal regulator or the FDIC Board of Directors; or seek a legislative change to vest this authority in the FDIC Chairman.

Following the failure of the Bank of Keystone in September 1999 and the issuance of the FDIC Office of Inspector General's October 1999 memorandum, the House Committee on Banking and Financial Services proposed legislation designed to strengthen the FDIC's ability to monitor and assess risk in those financial institutions for which the FDIC is not the primary regulator. Following a hearing on February 8, 2000, no action was taken on the legislation on the strength of the Comptroller of the Currency's representations during the hearing that there should be no problems with the FDIC's access to banks and that any disputes with the FDIC would be resolved at his level. Also during the hearing, the OTS Director made the following statement in her testimony:

> *With respect to our policies regarding FDIC participation in OTS examinations and FDIC requests to examine OTS-supervised thrifts, we have only one policy-the door is always open. We have told our regional directors that whenever the FDIC asks to go into a thrift, that request must be honored. If there are concerns-for example when the FDIC is involved in ongoing litigation against the institution – these are to be brought to the immediate attention of senior Washington staff so they can be quickly evaluated and resolved on a consistent basis. A second set of eyes is a benefit when an institution is showing signs of stress, and in numerous instances we have sought out FDIC participation in examining a problem institution.*

The OTS Director did not believe that legislation was necessary and that the legislation could run counter to productive interagency coordination. She made the following statement:

> *In my over-two-year tenure on the Board of the FDIC, no OTS backup supervision case has ever been brought to the Board, yet there has been effective OTS/FDIC coordination. The existing system of interagency coordination has worked well. Given the productive relationship we have with the FDIC as well as the mutual benefits arising out of FDIC's involvement in our supervision of thrift institutions, I believe this legislation is not needed.*

As was mentioned earlier in this report, there was a reluctance on the part of the FDIC examiners to raise their concerns to the FDIC's Board of Directors, which under current governing regulations was their next level of recourse. Their reluctance was based primarily on the absence of time and the lack of detailed information needed to support a case to the FDIC Board especially since Superior's last rating by the OTS was a composite "1."

In his October 2001 testimony to the Senate Banking Committee, the FDIC Director made the following observations with respect to the current rules under which the Board operates with respect to the FDIC's special examination authority:

> *...in 1995, during a time when the FDIC Board was shorthanded and was composed of just three members – the FDIC Chairman, the OCC Comptroller of the Currency and the Director of OTS, there was a Board Resolution passed by a vote of 2-1 which prohibited the FDIC from exercising backup authority unless it was brought to the attention of the Board of Directors of the FDIC. This had an inhibiting impact on our ability to engage in backup examination authority. And it is always a risk that will exist as long as the Board is comprised of members, of the current membership of the Board, and it jeopardizes the FDIC when we do not have a full Board and places the Chairman of the FDIC, potentially, at a disadvantage, unfortunately, in instances that could only be described as turf wars with the other regulators.*

During the 4th quarter of 2001, the FDIC Chairman directed the FDIC officials to work with the Office of the Comptroller of the Currency, Federal Reserve Board, and OTS in an effort to develop an agreement that would improve the Corporation's access to banks for purposes of performing special examinations and to provide DOS with more timely data on large banks. On January 29, 2002, the FDIC Board approved the agreement.

As the insuring agency, the FDIC strives to keep abreast of developments that occur in all institutions to determine their potential risks to the deposit insurance funds. Under the current established guidelines, when the primary regulator objects to the FDIC's participation in an examination, a well-prepared and documented case must be presented to the FDIC Board of Directors. While this process can be time consuming, it also can inhibit examiners from immediately pursuing and verifying apparent or suspected risks

that cannot be positively substantiated. The FDIC Manual of Examination Policies provides the following:

> *The examination function lies at the heart of the FDIC's ability to maintain public confidence in the integrity of the banking system and in individual insured institutions. Given the fundamental reasons for conducting a bank examination, access to all records and employees of the bank must be made available to the supervisory staff during an examination.*

When the FDIC identifies concerns and wants to gain a better understanding of the risks through an on-site presence, the FDIC should have unobstructed access.

GLOSSARY

Allowance For Loan And Lease Losses (ALLL)	Federally insured depository institutions must maintain an ALLL at a level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.
Billion Dollar Insured Depository Institution (BIDI)	The primary focus and purpose of the BIDI program was to determine the continued applicability of the currently assigned FDIC composite rating. Benefits of the program include: • Support for the Large Insured Depository Institution LIDI program by providing analysis of individual institutions • Support for the risk based premium system by providing timely ratings review • Identification of potential ratings differences with primary regulators • Analytical support for interim rating change documentation Note: The BIDI program was canceled in September 1999.
Call Report	An institution's quarterly Consolidated Report of Condition and Income which contains a balance sheet, income statement, and other detailed financial schedules containing information about the institution.
CAMEL(S) Rating	Financial institution regulators use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's Performance. Areas of financial and operational concern are evaluated and given a numerical rating of "1" through "5," with "1" having the least concern and "5" having the greatest concern. The performance areas, identified by the CAMEL acronym are: Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity. A sixth component, Sensitivity to Market Risk, Was added in January 1997 changing the acronym to CAMELS.
Cease and Desist Order (C&D)	A formal enforcement action issued by the regulator's Board Of Directors to a bank or affiliated party to stop an unsafe or Unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is not longer needed or the bank has materially complied with its terms.

Composite Rating	An overall rating given to a bank based on the six components of the CAMELS rating. A rating of "1" through "5" is given, with "1" having the least regulatory concern and "5" having the greatest concern. A description on the graduations utilized in conjunction with the performance ratings is as follows:	
	Rating "1"	Indicates strong performance, significantly higher than average.
	Rating "2"	Reflects satisfactory performance, performance which is average or above: this includes performance that adequately provides for the safe and sound operation of the bank.
	Rating "3"	Represents performance that is flawed to some degree and as such is considered fair. It is neither satisfactory nor unsatisfactory but is characterized by performance that is below-average quality.
	Rating "4"	Refers to marginal performance, significantly below average. If left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.
	Rating "5"	Considered unsatisfactory; performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, threatens the viability of the institution.
Concentration	A concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the Report of Examination. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital.	
Credit Enhancements	Credit enhancements may be either internal or external. Internal enhancements are created by redirecting internal cash flows. Examples include senior-subordinated structures and cash reserve accounts funded by the originator. External credit enhancements are not dependent on redirecting internal cash flows. Examples include letters of credit issued by banks, surety bonds issued by insurance companies, guarantees issued by financial assurance companies, and subordinated loans from third parties.	

Discount Rate	This is the interest rate used to convert future receipts or payments to their present value.
Division of Resolutions and Receiverships (DRR)	The division of the FDIC which plans and handles the resolution of failing and failed FDIC-insured institutions.
Excess Spread	This is the difference between the stated rate of return received on the loans and the stated rate of return paid on the securities.
Leverage Capital	Banks must maintain at least the minimum leverage requirements set forth in Part 325 of the FDIC Rules and Regulations 12 CFR §325.3. The minimum leverage requirement is a ratio of Tier 1 (Core) capital to total assets of not less than 3 percent or greater, depending upon the condition of the institution.
Overcollateraliza-tion	This is a type of credit enhancement in which the principal amount of collateral used to secure a given transaction exceeds the principal of the securities issued.
Par Value	The nominal or face value of a stock or bond certificate or loan. It is expressed as a specific amount marked on the face of the instrument. Par value is not related to market value, which is the amount a buyer is willing to pay for an item.
Prompt Corrective Action (PCA)	Part 325 of the FDIC Rules and Regulations, 12 CFR §325.101, et. seq, implements section 38 of the FDI Act, 12 USC §1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are not adequately capitalized. The following codes are used to describe capital adequacy: W Well Capitalized A Adequately Capitalized U Undercapitalized S Significantly Undercapitalized C Critically Undercapitalized
REMIC –Real Estate Mortgage and Investment Conduit	A type of collateralized mortgage obligation (CMO). REMICs divide cash flows into two different classes – regular and residual. Investors in each class receive payments of distinct priorities and timing. The regular-class instruments are classified as debt; residual-class instruments are classified as assets.
Residual Interests	Residual interests represent claims on the cash flows that remain after all obligations to investors and any related expenses have been satisfied. They represent funds required to build reserves and pay loan losses, servicing fees, and liquidation expenses.
Risk-Based Capital	A "supplemental" capital standard under part 325 of the FDIC Rules and Regulations, 12 CFR §325, Appendix A. II. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2) less certain deductions.

Risk-Weighting Assets	A system of calculating the risk-weighting of assets based on assigning assets and off-balance assets into broad risk categories, 12 CFR §325, Appendix A.II.
Section 10(b) of the FDI Act	Section 10(b), 12 USC §1820 (b) lists the power of the Board of Directors to appoint examiners to conduct regular and special examinations of financial institutions. Also, examiners shall have the power, on behalf of the Corporation, to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully the relationship between the institution and its affiliate and the effect of the relationship on the institution.
Section 10(c) of the FDI Act	Section 10(c) of the FDI Act, 12 USC §1820(c), authorizes the representative of an appropriate Federal banking agency to administer oaths and affirmations, and to examine and take and preserve testimony under oath as to any matter in respect to the affairs or ownership of any such bank, institution or affiliate.
Section 23(a)	Section 23(a) of the Banking Affiliates Act of 1982, 12 USC §371(c), establishes restrictions on transactions between financial institutions and their affiliates. These include restrictions on the dollar amount involved in the transactions and establishes collateral requirements for certain transactions with affiliates.
Section 23(b)	Section 23(b) of the Banking Affiliates Act of 1982, 12 USC §371(c)-1, places restrictions on transactions with affiliates. It requires transactions to be on the same terms and standards or at least as favorable as those prevailing for comparable transactions with a nonaffiliate. In the absence of comparable transactions, they must be on terms and circumstances that in good faith would be offered to or apply to nonaffiliated companies.
Sold With Recourse	A general ledger term meaning that the purchaser of a financial asset from an original creditor has a claim on the original creditor in case the debtor defaults. Specific arrangements to provide recourse arise in a variety of innovative transactions, including various types of securitized assets. Such arrangements can take many forms, including an explicit guarantee that credit losses will be reimbursed or the assets replaced by assets of similar quality or indemnification by a third-party guarantor for any losses.
Subprime borrower	A borrower whose credit is below good credit standards. These borrowers pose a greater risk and are characterized by paying debts late, filing for personal bankruptcy and/or having an insufficient credit history.
Thrift Financial Report (TFR)	OTS regulation, 12 CFR §562.1, requires the completion of the Thrift Financial Report (TFR) by all savings associations and affiliates. The TFR is filed electronically on a quarterly basis and is due no later than 30 days after quarter end, except for Schedule HC, Thrift Holding Company, and Schedule CMR, Consolidated Maturity and Rate, which are due no later than 45 days after quarter end. The TFR contains 14 schedules, which include financial statements and supplemental information filed on the thrift and its subsidiaries. All information on the TFR, including

	income and expense and cash flow data, is reported on a quarterly basis.
Thrift Institution	12 USC §1841(I) defines a "thrift institution" as: (a) a domestic building and loan or savings and loan association (b) non-profit cooperative bank without capital stock (c) a federal savings bank, or (d) a registered state-charted savings bank and holding company.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 CFR §325.2 (A), and is the sum of : • Common stockholder's equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock • Minority interest in consolidated subsidiaries; **Minus** • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 1 Leverage Capital Ratio	Tier 1 Capital divided by total assets 12 CFR §225, Appendix D.,II.a.
Tier 2 (Supplemental) Capital	Tier 2 Capital is defined in Part 325 of the FDIC Rules and Regulations, 12 CFR §325, Appendix A., I.A.2, and generally consists of: • Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; • Cumulative perpetual preferred stock, long-term preferred stock and Related surplus; • Perpetual preferred stock (dividend is reset periodically); • Hybrid capital instruments; • Term subordinated debt and intermediate-term preferred stock; and • Eligible net unrealized holding gains on equity securities.
Total Risk-Based Capital Ratio	The total qualifying capital divided by risk-weighted assets 12 CFR §325.2(w).
Uniform Thrift Performance Report (UTPR)	A report comparing an individual bank to its peer group.

APPENDIX A

Objectives, Scope and Methodology

We conducted this review at the request of Senator Sarbanes, Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. The objectives of our review were to analyze the causes of Superior's failure and to address nine topics requested by Senator Sarbanes related to the failure. The scope of the review included an analysis of Superior's operations from 1991 until its failure on July 27, 2001. We also evaluated the regulatory supervision of the institution over the same time period. We did not include audit tests and procedures beyond those needed to answer the stated objectives.

To accomplish our review objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the OTS from 1991 until 2001;
- Analyzed memorandums, visitation, and draft reports prepared by the FDIC from 2000 until 2001;
- Interviewed OTS management in Washington, D.C. and Chicago, Illinois;
- Obtained information from the Legal Counsel from the OTS Chicago Regional Office;
- Interviewed FDIC DOS examiners, case managers, capital markets specialists, and executive personnel from the Chicago Region;
- Interviewed FDIC Legal Division officials at the Chicago Regional Office and Washington D.C.;
- Interviewed FDIC DRR officials in Washington, D.C. and the Dallas Regional Office;
- Interviewed OTS examiners, capital markets specialists, and executive personnel from the Chicago Region;
- Interviewed FDIC accounting specialist and OTS Chief Accountant in Washington, D.C.;
- Researched residual interests;
- Researched Section 38 of the FDI Act;
- Researched 12 CFR Part 570;
- Reviewed OTS case files in Washington, D.C. and Chicago, Illinois;
- Reviewed DRR files relating to the closing of Superior;
- Reviewed records subpoenaed from Ernst and Young (E&Y);
- Reviewed pertinent OTS policies and procedures.

We performed the fieldwork at the DOS and OTS Regional Offices in Chicago, Illinois; the OTS and the FDIC Washington, D.C. Offices; the DRR office in Dallas, Texas; and DRR offices in Washington, D.C.

We conducted our review between August 1 and December 31, 2001, in accordance with generally accepted government auditing standards. However, the scope of our review was limited by the following factors:

- It is possible that some records may have been removed or misplaced in the process of closing the institution and were not available for our review.
- We are not certain that we received all records related to Superior that were in the possession of Ernst & Young and some records that were subpoenaed from E&Y were received too late in our field work to be fully analyzed.
- We did not have access to bank records other than those that were in the possession of the regulatory authorities or E&Y.
- We did not interview E&Y or bank management officials.

APPENDIX B

Introduction to the Securitization Process

In order to fully assess the activities at Superior Bank, FSB, a description of the securitization process and the various elements that are involved is necessary. The following information is provided to enable the reader to understand the operation of the securitization process. Once this is accomplished, Superior's activities and the accounting methods that they used will be more understandable.

The Definition of the Securitization Process

By definition, securitization is the process where interests in loans, generally mortgages, and other receivables, including credit cards and automobile loans, are packaged, underwritten, and sold in the form of asset-backed securities (ABS). One of the benefits of the securitization process is that it converts relatively illiquid assets (loans), into readily marketable securities with reasonably predictable cash flows. For financial institutions, it provides more liquidity, along with other benefits such as lower funding costs, a new source of servicing income, improved financial indices, potentially lower regulatory capital requirements, and added protection from interest rate risk.

For investors, the securitization process permits them to acquire a security with relatively no or minimal credit risk. The use of either internal or external (or both) credit enhancements also helps to insulate the investor from the credit risks associated with the loan portfolios.

The Securitization Process and the Parties Involved

In its simplest form, the securitization process begins with consumers borrowing money from a financial institution. The financial institution will accumulate the various loans that it wants to securitize, for example residential mortgages. Once a certain optimum level of loans has been funded, the institution will segregate the loans into homogeneous pools with respect to cash flow characteristics or risk profiles. At this point, a trust or special purpose corporation (SPC), which is usually a bankruptcy-remote entity, is formed. The loan pools are then transferred to the SPC.

A trustee is retained to administer the trust that holds the underlying ABS collateral, the loans. The trustee's responsibilities can include the following functions:

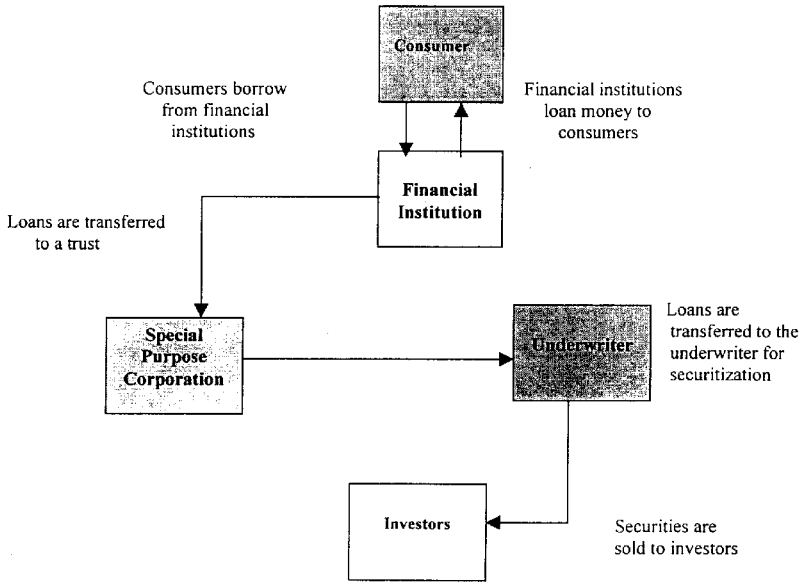
- ensure that daily cash collections forwarded by the servicer to the trustee are invested in eligible investments;
- disburse all cash collections to the appropriate entities;
- determine the appropriate certificate rate for variable rate issues at each repricing date;
- ensure that the seller and the servicer are in compliance with all legal documents governing each transaction; and
- serve as the collateral agent for the benefit of the certificate holders.

The trustee acts in a fiduciary capacity with the preservation of the investors' rights as its primary concern.

The next step is the underwriting process. The underwriter is responsible for advising the seller on how to structure the transaction for pricing and for marketing the security to the investor. The underwriters will package the loans into a securitized instrument and market it to investors. While these main areas comprise the overall structure of the securitization process, there are several intervening roles that are interspersed between these steps. These steps are not necessary to understand the overall concept of the securitization process; therefore, they are not included in this discussion.

The structure of a security and the terms of investors' interests in the collateral can vary considerably. The structure will depend on factors such as the type of collateral supporting the security, the wants and needs of investors, and the use of credit enhancements, both external and internal. Often the securities are structured to re-allocate the risks embodied in the underlying collateral into subparts that match the needs of the investors and the financial institution. A diagram of the overview of the securitization process is detailed in Figure 4.

Figure 4: The Securitization Process



Some of the different roles that are also included in the securitization process are those of servicers and credit enhancers. Each security issue has a servicer who is responsible for collecting the principal and interest payments and for transmitting these funds to either the trust or to the investors. Generally the financial institution that is supplying the loans retains the role of the servicer. This function enables the institution to generate fee income in addition to the other income generated by the securitization process.

Credit Enhancements and Their Role In Protecting Investors Against Losses

A credit enhancement is a method of protecting investors in the event that cash flows from the underlying loans are insufficient to pay the interest and principal due to the investors in a timely manner. Most rating agencies require some form of credit enhancement in order to gain a AAA rating for the security and will dictate specifics regarding the amount necessary to achieve a given rating. Usually, external as well as internal credit enhancements are used to satisfy the requirements for an investment grade rating.

An external credit enhancer in the form of an insuring company may be involved in the process. This is a third party who provides a guarantee for generally a portion of the issue (the amount and conditions under which it will be paid are detailed in the agreements between the involved parties). Their responsibility is to ensure that investors receive their payments in a timely manner, even if the servicer has not collected all the funds from the obligors.

Internal credit enhancements are generally provided by the financial institution as the seller/originator of the issue. Generally, internal credit enhancements are in the first loss position and are retained by the financial institution. This portion is generally referred to as the residual interest. The residual interest is the difference between the stated interest rate on the loans collateralizing the security less the stated interest rate on the security, expenses, and losses. The residual interest represents claims on the cash flows that remain after all obligations to investors and any related expenses have been paid, which normally include funds to build reserves and pay loan losses, servicing fees, and liquidation expenses. The internal credit enhancement provides credit protection by redirecting the internal cash flows. This provides the rationale for the difference in interest rates offered to the investor versus the interest rates charged on the loans. Since the risk of credit loss is borne by the financial institution, the investor should receive a lower rate of return because of the safety of his portion of the investment. The higher risk of loss to the financial institution is rewarded with a potential higher return on investment. Generally, the higher the risk, the higher the potential return. Table 20 illustrates a simplified calculation for excess residual interest.

Table 21: Calculation of Excess Residual Interest

BEGIN WITH:	Gross Interest
LESS:	Pass Through Rate to Investors Delinquency Advances (Net of recoveries) Servicer's Fees Servicing Advances & Liquidation Expenses Reserve Deposits Realized Losses
PLUS:	Prepayment Penalties Collected Interest on Reserves
EQUALS:	Excess or Residual Interest

Source: FDIC's DRR

Recourse provisions are guarantees that require the originator to cover any losses up to a contractually agreed-upon amount. These provisions are usually in the form of a spread account. This is an account that is established with the difference between the interest earned on the assets in the pool and the interest that is paid out to investors. These funds accumulate to an agreed-upon level to protect against losses in the securities. This interest spread is accumulated to repay investors in the event that unexpected losses occur.

Overcollateralization is another form of credit enhancement. This occurs when the value of the underlying assets or collateral exceeds the face value of the security. Because the collateral is worth more than the amount owed to investors, there is a margin of protection against unanticipated losses. Financial institutions can use other methods to originate and accumulate an OC account. Another method of establishing an OC account is discussed in the section on Superior Bank's securitization activities.

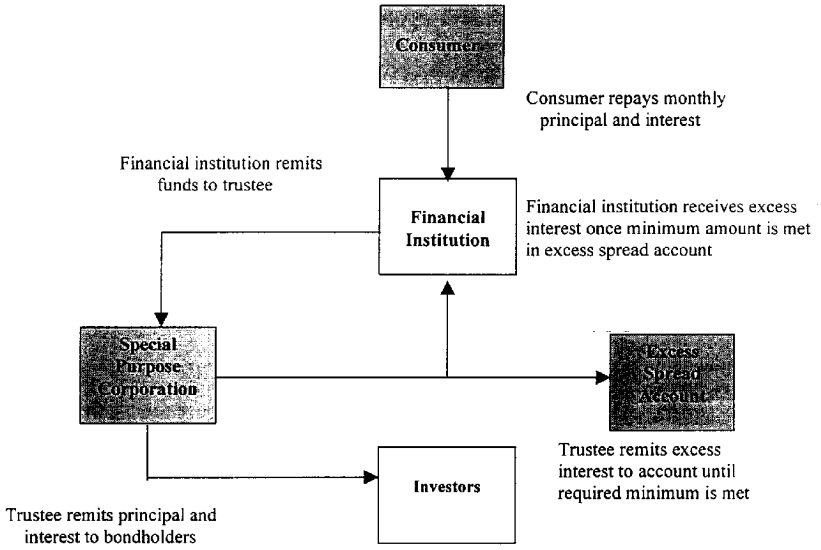
Flow of Funds Through a Securitization

The above sections relate the fundamental elements of how the securitization process is structured. As detailed above, the lending and investment process begins with the consumer borrowing money from the financial institution and ends with the issuance of securities to investors. The money from the investors is then used by the institution to fund more loans.

Now, to fully grasp the entire picture, the repayment of the funds through the securitization process will be discussed. First, the borrower repays the principal and interest on the loan. The servicer, who is generally the financial institution, accumulates the total receipts (which are usually received monthly on residential mortgages and other

consumer loans). The servicer then forwards the specified required amount, which may equal the proceeds received less a servicing fee, to the trustee of the special purpose corporation. The trustee distributes to the investors the principal and interest payments that are due on the securities. If a spread account, such as an OC account, is established, the excess interest is placed in the account until a required minimum level is achieved. The required minimum levels are established by the guaranteeing agency and included in the securitization agreements. The level is generally a percentage of the outstanding balance of the security. Once this required level has been reached, the excess interest is remitted to the financial institution. This flow of funds is detailed in figure 5 below.

Figure 5: Flow of Funds Through the Securitization Process



Accounting for Securitizations

The accounting methodologies used to establish and maintain the values associated with the various components, such as the gain on sale income and credit enhancements, including the OC account and the residual interests, were established in a series of Statements of Financial Accounting Standards (FAS). Until the mid 1990s, accounting principles applicable to securitizations were set forth in FAS 77, *Reporting by Transferors for Transfers of Receivables With Recourse*, and FASB Technical Bulletin 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs) (Tech Bulletin 85-2)*. FAS 77 established the concept of "gain on sale" accounting. Gain on sale accounting requires the recognition of gain or loss if certain criteria for a bona fide sale were met. In

determining the gain on sale, the selling price of the receivable is to be adjusted for such items as the debtor's failure to pay when due, and the estimated effects of prepayments. Tech Bulletin 85-2 provided various criteria as to when gain on sale accounting was appropriate for the types of transactions (collateralized mortgage obligations) to which it applied. FASB subsequently noted that confusion in applying these sets of principles led FASB to reconsider these pronouncements and subsequent guidance. FASB's reconsideration led to the issuance of FAS 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

FAS 125 prescribed the accounting for transfers of financial assets, including securitizations. As such, FAS 125, which became effective for transfers occurring after December 31, 1996, governed securitizations of mortgage and auto loans initiated by Superior since that date. In promulgating FAS 125, FASB recognized that financial assets and liabilities can be divided into a variety of components, for example, servicing rights, residual interests (e.g., residual interests in securitizations), recourse obligations, and pledges of collateral.

Regarding securitizations, FAS 125 prescribes the accounting treatment when (a) a securitization takes place and (b) the transferor (e.g., Superior) presents its financial statements ("subsequent measurement") which indicate the value of the securitizations. When a securitized transaction takes place, the transferor carries on the balance sheet any retained interests, including residual interests and the "beneficial interests" transferred to a qualifying special-purpose entity, such as a trust. In so doing, the transferor allocates its previous carrying values of the assets (e.g., loans) sold and any retained interests, based on their "fair value" at transfer date. "Beneficial interests" are the rights to receive cashflow to a trust, including residual interests.

"Fair value," means a quoted market value for the securities involved, if there is an active market for the securities. If there is no quoted market value, an estimate may be made, based on the best information available. One method for estimating is a present-value analysis of future cash flow using a discount rate commensurate with the risks involved. The analysis should incorporate assumptions that market participants would use regarding:

- future revenues
- future expenses
- interest rates
- default rates
- prepayment
- volatility

"If this method is used, the estimates are to be based on reasonable and supportable assumptions. All evidence is to be considered, with more weight given to evidence that can be verified objectively."

Once the transfer of assets is completed, the transferor records a gain if the cash proceeds of the transaction, net of assets and liabilities incurred (such as interest rate swaps and recourse obligations), that are received by the transferor exceed the allocated book value (as described above) of the assets (e.g., loans) sold. This gain on sale treatment assumes that the transferor has surrendered control over the transferred assets. If control is not surrendered, the transaction must be accounted for as secured borrowing with pledged collateral.

Regarding the second aspect of accounting for securitizations, that is, when the transferor (e.g., Superior) prepares financial statements, the transferor is required to measure residual interests, loan, and other receivables that are subject to prepayment as if they were debt securities, in accordance with FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Accordingly, the transferor must determine the fair value of the interests as of the financial statement (balance sheet) date, with any unrealized gains or losses either recorded in earnings or presented in "other comprehensive income", depending on whether management considers the securities as trading securities (actively traded and intended for sale in the near term) or as "available for sale".

FAS 125 was replaced by FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, effective for transactions occurring after March 31, 2001. FAS 140 carried over many of the provisions of FAS 125 but requires, among other things, additional disclosures in the financial statements about securitizations. Because Superior did not engage in any securitizations after March 31, 2001, the provisions of FAS 140 do not apply.