

**MATERIAL LOSS REVIEW
OF
SUPERIOR BANK, FSB**

OIG-02-040

February 6, 2002



Office of Inspector General

The Department of the Treasury

Contents

Audit Report 3

 Results in Brief 4

 Background 8

 Findings and Recommendations 11

 Finding 1 Causes of Superior’s Failure 11

 Finding 2 OTS’ Supervision of Superior 18

 Finding 3 Prompt Corrective Action 30

 Recommendations 36

Appendices

Appendix 1: Objectives, Scope, and Methodology 41

Appendix 2: Superior’s Securitization Structure and Process 45

Appendix 3: CCFC and Superior’s Organization Structure 47

Appendix 4: Chronology of Significant Events 48

Appendix 5: Glossary of Terms 55

Appendix 6: Management Comments 58

Appendix 7: Major Contributors To This Report 60

Appendix 8: Report Distribution 61

Abbreviations

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

Contents

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

*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 subprime¹ 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.

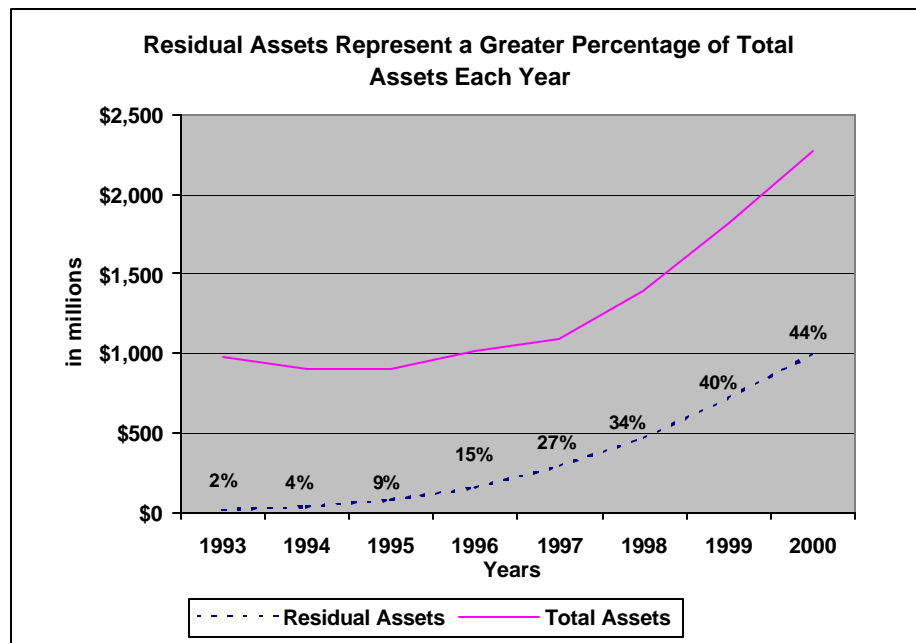
The methods and assumptions used to properly value the residual assets were critical judgments by thrift management. For example, management needed to consider factors such as the default rate of the underlying loans (credit risk), the rate borrowers might prepay loans (prepayment risk), and the interest 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 (%)
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, policies, 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%	<ul style="list-style-type: none"> 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%	<ul style="list-style-type: none"> 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%	<ul style="list-style-type: none"> 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%	<ul style="list-style-type: none"> 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%	<ul style="list-style-type: none"> TFR inaccurate for classified assets, capital, and brokered deposits 	NONE
10/27/97	1/211121	\$334	218%	<ul style="list-style-type: none"> 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%	<ul style="list-style-type: none"> Understated classified assets Inaccurate prepayment assumptions used for residual assets Unacceptable auto loan delinquencies 	NONE
9/21/99	Field Visit	n/a	n/a	<ul style="list-style-type: none"> Understated classified assets 	NONE
1/24/00	4/434221	\$869	308%	<ul style="list-style-type: none"> 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%	<ul style="list-style-type: none"> 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%	<ul style="list-style-type: none"> 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.

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
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.

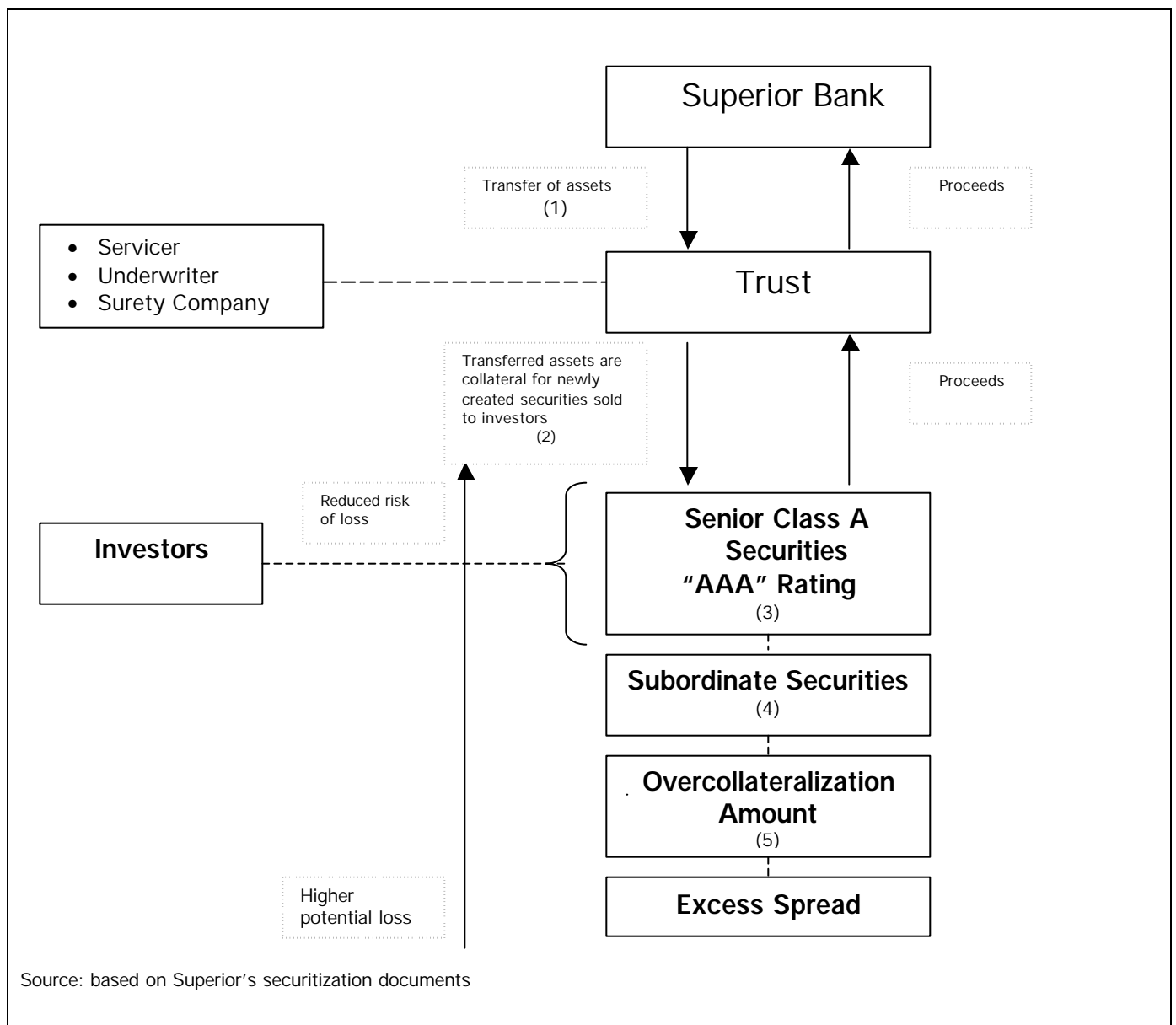
We initially discussed the contents of the 24 subpoenas with OTS on November 19, 2001, and requested copies of the subpoenas from OTS Chief Counsel's office on November 29, 2001. We again requested the information in a memorandum to OTS dated December 17, 2001. In response to the memorandum, we were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

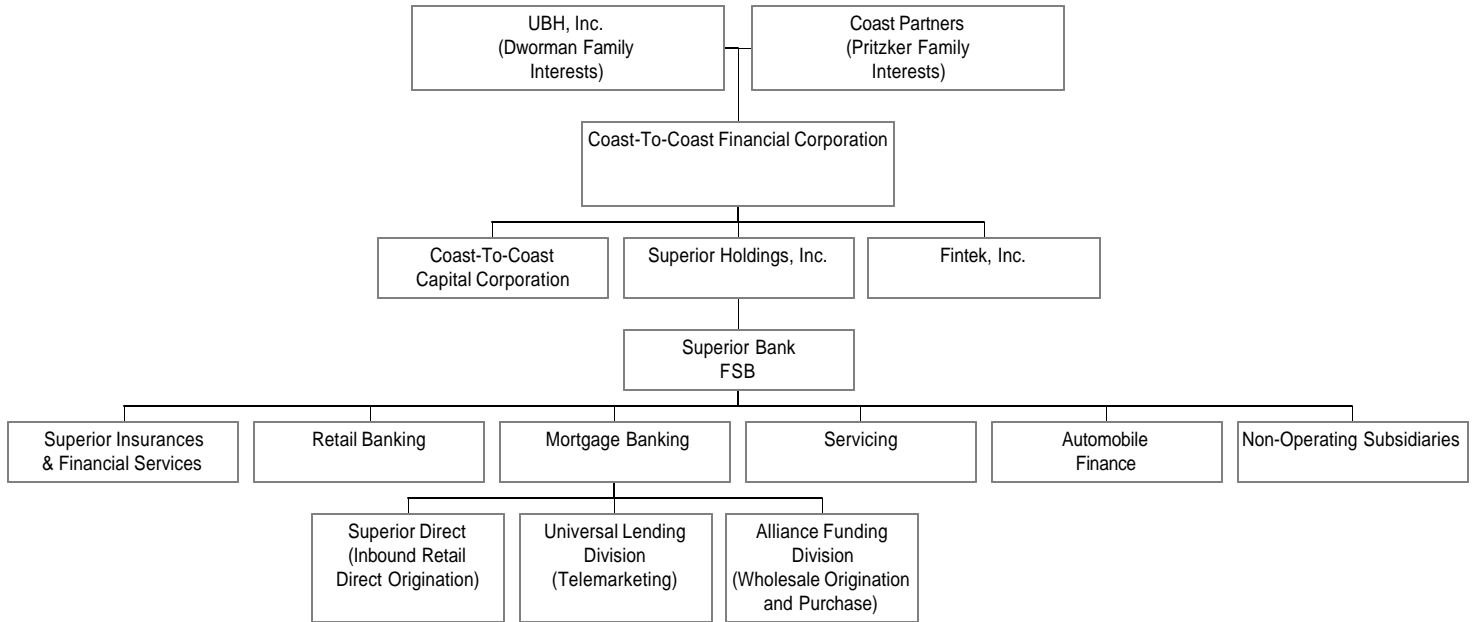
Superior's loan securitization activity consisted of originating and purchasing subprime loans, pooling the loans together, packaging them as "asset-backed securities", and selling the securities to investors. The thrift relied on two securitization structures. The first type used a senior/subordinated 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



- (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

Appendix 4
Chronology of Significant Events

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.

Appendix 4
Chronology of Significant Events

- 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.

Appendix 4
Chronology of Significant Events

- 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.

Appendix 4
Chronology of Significant Events

- 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: <u>C</u> apital adequacy, <u>A</u> sset quality, <u>M</u> anagement administration, <u>E</u> arnings and <u>L</u> iquidity. An additional component addressing <u>S</u> ensitivity 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

Appendix 6
Management Comments

-2-

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.

Office of Inspector General, Office of Audit

Delores V. Dabney, Co-Project Manager
Garrett W. Gee, Co-Project Manager
Joseph K. Eom, Auditor-in-Charge
Aldon K. Hedman, Auditor
Kathleen G. Hyland, Auditor
Ronda R. Richardson, Auditor

U.S. Department of the Treasury

Office of the Under Secretary for Domestic Finance
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