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INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY

TESTIMONY BEFORE THE SENATE COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

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

As you know, Superior was supervised by the Office of Thrift Supervision (OTS), an agency of the Department of the Treasury. Under the provisions of the Home Owners Loan Act (HOLA), OTS is responsible for chartering, examining, supervising, and regulating federal savings associations and federal savings banks.

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

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

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

OVERVIEW OF SUPERIOR

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

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

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

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

CAUSES OF SUPERIOR’S FAILURE

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

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

Rapid Growth And Asset Concentration

The impact of the residual assets accounting and valuation adjustments on capital was extensive and occurred in just a year's time. Superior's capital fell three capital categories from "adequately capitalized" in March 2000 to "critically undercapitalized" by March 2001. Such large capital depletion due to a single asset type clearly reflected an unsafe and unsound practice and condition due to an asset concentration. From the beginning, Superior's concentration in residual assets was apparent. Those assets were valued at $18 million or 33 percent of tangible capital in 1993, and grew to over $996 million or 352 percent of tangible capital by 2000.

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

Deficient Risk Management Systems

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

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

Liberal Underwriting

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

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

Unreliable Loan Loss Provisioning

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

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

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

Economic Factors

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

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

Non-responsive Management to Supervisory Concerns

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

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

OTS’ SUPERVISION OF SUPERIOR

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

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

Delayed Supervisory Response

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

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

- Superior's residual assets clearly surpassed that of all other thrifts in the country. At one point in time, the interest strip component of residual assets stood at $643 million - more than the combined total for the next highest 29 thrifts supervised by OTS. In terms of Superior's capital exposure, this residual component amounted to 223 percent of capital as compared to 72 percent for the next highest institution.

- OTS headquarters advised field officials in 1997 that subprime loans were considered high risk and warranted additional examiner guidance.

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

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

Ineffective Enforcement Action

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

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

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

Examination Weaknesses Over Valuation and Accounting Problems

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

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

- OTS lacked detailed examination procedures covering third party service providers such as Fintek. Although a 1991 OTS examination bulletin describes some of the risk of using a third party service provider such as consultants, it does not outline the supervisory obligations of an examiner in this area.

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

A senior OTS official indicated that prior to 2000 there was no compelling reason to be concerned with the residual valuations, and examiners expressed confidence in Superior's management who appeared knowledgeable of the asset securitization business. However, we believe there were indications that closer and earlier on-site examination coverage over the valuation process was warranted. Besides the concentration and subprime risks, Superior did not provide sufficient internal audit coverage of the valuation area. In fact, audit committee meetings were infrequent and Fintek operations were “off-limits” despite the many critical services that were provided to Superior.

Undue Reliance Placed on External Auditors

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

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

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

Factors Impacting Prompt Corrective Action

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

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

Delayed Examiner Follow-up/Delayed Detection

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

- Delayed examiner follow-up on the 1994 and 1995 reported ALLL deficiencies effectively resulted in overstated capital levels as early as 1996, and again in 1997 and 1999. Had Superior's true capital level been known, perhaps the PCA restriction over the use of brokered deposits could have been invoked earlier to stem the growth and buildup of high risk, residual assets.

- The delayed detection of the $270 million incorrect accounting practice in 2000 and the inaccurate $150 million residual asset valuations in May 2001 also overstated capital levels. Had these two problems been detected earlier, Superior would likely have been subject to several PCA provisions earlier, such as submitting a capital restoration plan, PCA's 90-day closure rule, and the severest PCA restrictions such as requiring FDIC prior written approval for certain transactions.

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

Indications of Regulatory Forbearance

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

Valuations Delayed

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

May 24, 2001.

Assets Not Recorded

Another example of forbearance relates to Superior applying an accounting rule (i.e., “right of setoff”) that allowed it to exclude certain assets from being reported in the March 2001 TFRs. The associated assets were loans that Superior had committed to sell, and Superior’s accounting treatment effectively served to keep their regulatory capital above the “critically undercapitalized” level. The sales transaction did not meet either regulatory or accounting standards for the right of setoff treatment. Again it appears OTS’ approval of the capital restoration 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 consisting of $81 million in residual assets from the holding company. The contribution effectively served to keep Superior’s capital above the “critically undercapitalized” level. OTS’ Regulatory Handbook does not generally permit the inclusion of non-cash assets for determining tangible capital. Although the OTS handbook does provide some flexibility on a case-by-case basis, Superior's tenuous financial condition at the time seemed to have merited closer adherence to the prescribed regulatory policy. OTS requested on May 3, 2001 that Superior provide additional documentation in the form of legal and accounting opinions in support of the transaction. Aside from providing Superior additional time, it seemed incongruous that OTS would accept the residual asset contribution at a time Superior needed to reduce, not increase, its residual asset exposure.

Preferential Application of Risk-Based Capital Requirements

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

According to an FDIC memo to OTS, the relief afforded Superior was not consistent with existing capital treatment by the other regulatory agencies on recourse arrangements.

In our report, we also discuss two other observations relative to PCA. We determined that Superior might have violated the PCA mandatory restriction against paying excessive bonuses to senior officers. Between March and July 2001, a total of $220,000 in bonuses had been paid to 10 senior executives. An OTS official said he had not been aware of the bonuses.

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

STATUS OF ON-GOING AUDIT AND INVESTIGATION

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

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

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