

Office of Inspector General



February 6, 2002
Audit Report No. 02-005

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





February 6, 2002

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

Dear Mr. Chairman:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sincerely,

[Electronically produced version; original signed by Gaston L. Gianni]
Gaston L. Gianni, Jr.
Inspector General

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INTRODUCTION

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

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

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

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

RESULTS IN BRIEF

The failure of Superior Bank was directly attributable to the Board of Directors and executive management ignoring sound risk diversification principles as evidenced by excessive concentrations in residual assets² related to subprime³ lending. This risk was

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

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

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

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

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

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

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

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

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

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

Ineffective Board of Directors and Executive Management

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

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

Superior's management apparently either misunderstood or disregarded the risks associated with the securitization process and the methods to control those risks.

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

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

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

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

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

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

Improper Accounting and Inflated Residual Interest Valuations

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

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

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

OTS Did Not Aggressively Limit the Risk Assumed by the Bank

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

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

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

Limited Cooperation Among Federal Regulators

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

Untimely and Ineffective Prompt Corrective Actions

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

BACKGROUND

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

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

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

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

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

Superior's Shift to Mortgage Lending Operations

Starting in 1993, Superior's management began to focus on expanding the institution's mortgage lending business. The owners of CCFC founded a mortgage banking entity known as Alliance Funding Company, Inc. (Alliance) in 1985. In 1990, the owners contributed Alliance to CCFC. From January 1991 until December 1992, Alliance was owned and operated by CCFC and was an affiliate of Superior. Alliance specialized in originating and selling first and second home mortgage loans to non-conforming borrowers. In December 1992, CCFC merged Alliance with Superior and Alliance became a division of the institution. Superior entered the securitization arena in 1993 and, due to the incorporation of the mortgage company, Alliance was able to provide a supply of subprime residential mortgages for Superior to fund, package, and sell to parties who would complete the securitization process. As with most mortgage bankers, Superior was generally not holding these loans in its portfolio, but rather it was securitizing the loans. Superior, like many issuers, held on to the securities with the greatest amount of risk and provided significant credit enhancements⁴ for the other securities.

Superior Bank's Securitization Process and Accounting

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

First Methodology

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

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

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

Second Methodology

For the remainder of 1994, Superior used a junior/senior securitization structure. These transactions involved issuing AAA rated securities equal to approximately 90 percent of the underlying mortgages as senior bonds. The remaining 10 percent were issued as junior bonds with a potentially lower rating. The junior bonds became the credit enhancement for the senior issue. In other words, the excess spread⁵ account and the junior bonds would absorb any losses up to the amount of the junior bonds issued before the senior class would suffer any loss. The excess spread account absorbed losses first. As long as the excess spread was sufficient to absorb the losses, there was little if any threat that the junior class would have to absorb any losses. Therefore, the junior class was only subject to nominal risk of loss. The junior bonds were either retained by the institution or sold to a third party at par.

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

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

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

Third Methodology

Superior began using a reconfiguration of the overcollateralization⁶ (OC) account in 1995, replacing the first and second methodologies, and used this method until they ceased securitization activities in June 2000. In addition to the securitizing of the subprime residential mortgages, Superior began an automobile division in 1994. This division originated and securitized subprime⁷ auto loans although on a much smaller scale than the operations of the mortgage division. The economies of the third accounting methodology afforded Superior the most advantageous method of increasing revenues through their securitization activities by permitting Superior to build the OC account incrementally over time with the excess interest they earned from the securitizations rather than establishing the bulk of the account at the onset of the transaction.

Superior's Securitization Process Using the Third Methodology

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

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

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

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

Over the ensuing months, the excess interest spread⁸, which normally would have been remitted to Superior, was transferred to the OC account. The excess spread was segregated in this account until a minimum percentage requirement was attained as specified in the securitization agreement between Superior and the surety or insurance company. The funds were then used to repurchase outstanding issues of the bonds. By retiring the bonds earlier, the OC account increased and less interest expense was paid on the outstanding bonds. After the required minimum level in the OC account was reached, the excess interest either reverted to Superior or was used either partially or in its entirety to repurchase additional outstanding bonds from the issue. If any losses on the underlying loans were incurred, either the excess interest spread or the collateral in the OC account was used to absorb the losses. If the OC account was required to absorb losses, which would reduce the balance in the account, the residual interests would be required to replenish the OC account.

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

Superior Bank's Demise

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

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

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

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

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

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

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

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

The Superior Bank Board of Directors was not receptive to the Office of Thrift Supervision's (OTS) regulatory recommendations for placing limitations on the excessive growth of residual assets⁹ held by the institution. The board did not refrain from increasing the residual asset balance until the OTS issued a Part 570¹⁰ directive in July 2000 requiring the institution to file a plan to cease their activities in this area. Superior Bank's management made a decision to expand the residual assets in 1993 at the onset of the securitization program. The inordinate growth of the residual assets until the restrictions were placed on the institution led to an excessive concentration in these high-risk assets. Problems were noted with Superior's high-risk lending program. Additionally, Superior could not support the assumptions pertaining to the discount rate at the 2000 examination. Despite the unqualified audit opinions from E&Y, during the October 2000 visitation the FDIC and OTS examiners determined that the accounting methodology applied to the overcollateralization (OC) account was incorrect. The effect of these two events, the overvaluation of the residual interests (\$150 million) and the miscalculation of the OC account (\$270 million), resulted in Superior suffering losses totaling approximately \$420 million for these two accounts.

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

¹⁰ Part 39 of the FDI Act requires each appropriate federal banking agency to promulgate final regulations under this Act, which are safety and soundness standards. These standards encompass three broad areas including operational and managerial standards, asset quality, earnings, and stock valuation standards, and compensation standards. 12 CFR Part 570 and the guidelines in its appendixes were issued by the OTS as required by Part 39 of the FDI Act. This section addresses the submission and review of safety and soundness compliance plans and issuance of orders to correct safety and soundness deficiencies.

Failure of the Board of Directors to Provide Adequate Oversight of Superior

Despite warnings from the Office of Thrift Supervision (OTS), the board did not impose a limitation on the residual interests that Superior recorded. Superior embarked on the full-scale operation of the securitization business directed at borrowers with non-conforming credit histories in the first quarter of 1993 and added the subprime¹¹ automobile division in 1994. The OTS maintained an annual presence and conducted safety and soundness examinations each year at Superior from 1991 through 2001, with the exception of 1998. After Superior became involved in the securitization process in 1993, the OTS examiners recommended in 1994 that the board establish limits for the amount of securitizations that they would permit the institution to carry on its books. The OTS also indicated the potential risks associated with the increasing volume of residual assets. The OTS listed the residual assets as a concentration in their examination reports; however, they stated that their concern was mitigated due to Superior's capital levels. Management was permitted to continue adding these high-risk credit enhancements. The addition of residual assets was only curtailed when the OTS issued a Part 570 directive to Superior in July 2000 to formulate a plan to limit the residual interests to 100 percent of Tier 1 capital.

Superior was designated as a problem institution shortly after the January 2000 examination, in which the Federal Deposit Insurance Corporation (FDIC) participated, when its composite rating was downgraded from a composite "2" to a "4." The downgrade was attributable to Superior's high-risk lending activities. Another contributing factor was management's liberalization of the assumptions used in the valuation process following the January 1999 OTS examination. The examiners levied specific criticisms relating to the residual interests and the unrealistic assumptions that management used to value the assets. Also, there were numerous problems with the level of adversely classified assets¹², particularly in the auto division, and management's reflection of these assets in the Thrift Financial Reports (TFRs). The OTS, with FDIC participation, conducted a visitation of the institution in October 2000. Although bank management, on behalf of the board, informed the OTS that the deficiencies noted in the 2000 examination had been corrected, the visitation proved otherwise. Loss classifications that should have been charged-off were renamed and reclassified on the balance sheet. Some of the loss classifications had been eliminated; however, the overall corrective action taken in response to the reports was less than satisfactory. The board had failed its fiduciary responsibility to ensure that management abided by instructions given by the OTS.

Unsupported assumptions connected with the asset valuation problems continued into the 2001 examination. Large write-downs were required for the overcollateralization (OC) account and eventually for the residual interests. The institution was on the brink of

¹¹ The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

¹² Adversely classified assets are allocated on the basis of risk. Classifications are expressions of different degrees of risk of a common factor – the risk of repayment.

insolvency when the OTS issued a Prompt Corrective Action (PCA) Directive on February 14, 2001. The owners began negotiating for a recapitalization plan with the OTS. When the time came for the owners to implement the final plan and inject the necessary capital into the bank, the owners did not implement the agreement.

Superior's Management Decision to Expand High-Risk Assets Depleted the Capital Base

As mentioned above, Superior Bank began engaging in mortgage securitizations comprised of loans to borrowers with non-conforming credit profiles during the first quarter of 1993. Although the institution had several other divisions, such as the retail division that made more traditional types of loans, Superior adopted the securitization process as its primary business with a focus on mortgage lending. During 1994, Superior incorporated automobile lending into its securitizing activities. By June 1995, the residual assets became a concentration at the institution in excess of 100 percent of capital. As early as 1994, the OTS recommended that Superior's board place limits on the amount of residual assets that would be permitted in the institution. The board did not heed this recommendation and did not make any attempts to curb the growth of the residual assets until the OTS imposed a Part 570 directive in July 2000. (See Topic 2 for more details on the levels of concentrations and the valuation of the residual assets at various times during Superior's life.)

Beginning in 1998, Superior's management decided that they wanted to further expand this segment of their business. However, as they attempted to expand this area, the credit quality of the underlying loans in the securitizations began to deteriorate as evidenced by the increase in delinquency and loss rates. The growth coupled with management's liberal assumptions¹³ enabled Superior to record a large income based on "gain on sale" accounting. These gains were imputed¹⁴ and recorded; however, the bank had not received the cash finalizing the transaction. Based on the accuracy or inaccuracy of the assumptions, the income had not been realized even though it was recognized as a gain for financial reporting purposes. (Refer to Topic 5 for a detailed discussion of Superior's earnings.)

At the January 2000 examination, the examiners criticized the high-risk lending activities and downgraded the institution's composite rating to a "4." Additionally, liberal and unsupported assumptions used by Superior to value the residual interests were also criticized. The examiners questioned whether the provisions of Financial Accounting Standards (FAS) 125 were applied correctly to the OC¹⁵ account. During a review of Ernst & Young's (E&Y) audit workpapers, a memo was discovered in the file that

¹³ Assumptions must be made related to the loss rates, prepayment speeds, and discount rates in order to value the residual interests.

¹⁴ Imputed gains are generated from the sale of securitized loans, and the calculations used to measure those gains are based on various assumptions and estimates that are subject to change.

¹⁵ The overcollateralization account is a type of credit enhancement, which is a method of protecting investors from losses if the cash flows from the underlying loans are insufficient to pay the principal and interest due on the securities. Refer to Topics 2 and 4 for a more detailed discussion of the OC account.

indicated Superior had applied FAS 125 accurately. The OTS and the FDIC examiners accepted E&Y's conclusions. After the 2000 examination was completed, the institution's composite rating was downgraded due to various deficiencies including the high-risk lending program, the use of unsupported liberal assumptions associated with the residual interests, and the potential overvaluing of the OC account, all of which could have had a negative impact on Superior's capital position. At the conclusion of the examination, Superior was instructed to revalue the residual interests with supportable assumptions. By June 30, 2000, the residual assets equaled 345 percent of tangible capital. In July 2000, the OTS issued a Part 570 Directive which required the board to develop a plan in compliance with the OTS's Part 570 to reduce the level of residual assets to no greater than 100 percent of Tier 1 capital within a 1 year time period.

The OTS and the FDIC returned in October 2000 for a visitation to determine if the deficiencies noted in the 2000 examination were addressed and corrected. Instead of improvement, the examiners found that conditions were deteriorating. The examiners determined that the accounting treatment used to value the OC account was incorrect. It was during this visitation that the different perceptions of the valuation of the OC account among the examiners, E&Y, and the institution culminated. After numerous discussions between the institution, the regulators, and the accountants, it was decided that the accounting methodology was incorrect and the OC account was overvalued. E&Y conducted an analysis of the account and determined that the OC account and the residual interests would require substantial write-downs. The write-downs had a detrimental impact on Superior's capital position. The write-downs and losses, coupled with the owners' unwillingness to recapitalize the institution resulted in the OTS closing Superior on July 27, 2001.

External Auditors Failed to Ensure Proper Accounting

When Superior began the securitization process, the OTS evaluated the assumptions that Superior used at the OTS's annual examinations to validate the valuations. In 1996, the OTS brought in a specialist from its Southeast Region to review all of the residual interest assets. The examination reports reflected no deficiencies with the assumptions that Superior was using to value the residual assets. The 1997 and 1999 examination reports did not reflect any findings relating to the assumptions Superior was using. However, following the 1999 examination, Superior liberalized its assumptions, which increased the value of the residual interests.

When Superior initially recorded the residual interests, it used a 15 percent discount rate in the present value calculation to establish the value of the residual interests. In the January 2000 OTS examination, it was noted that Superior was using an 11 percent discount rate. Bank management indicated that the discount rate was reduced after the expected ongoing prepayment experience was more estimable. Management's change from 15 percent to 11 percent during 1999 created substantial additional value in the residual interests. Superior did not have adequate documentation to support this reduction in the discount rate. At the June 30, 1999 audit, E&Y, Superior's external auditors opined that the 11 percent discount rate was valid; however, the information that

the firm used to support this contention was stale. Additionally, E&Y only performed limited testing of the residuals. The OTS recommended that Superior revalue the residual interests using a 15-percent discount rate. The FDIC's Division of Resolutions and Receiverships personnel who reviewed the residual interests and their underlying loan pools after Superior was closed stated that a more accurate discount rate for these assets would be in the range of 20-25 percent.

The OTS and the FDIC regulators determined that the accounting methodology applied to the OC account was not correct. According to the OTS and the FDIC, E&Y misapplied the provisions of FAS 125 by not calculating present value to determine the value of the OC account. The Financial Accounting Standards Board issued "Question and Answer" guidance on FAS 125 in September 1998, December 1998, and in July 1999. The information in the December 1998 and the July 1999 guidance supported discounting the value of credit enhancements for the period in which the funds are restricted. According to the securitization agreements, the OC account was restricted and the funds were not immediately available to Superior. The OC account was to be released incrementally over the life of the securitization. Therefore, the OC account should have been discounted to reflect this period in which the account balance was restricted and not available for Superior's use. This methodology is in keeping with "cash-out" accounting, which requires the discounting of the value until the funds are released to the entity. Conversely, "cash-in" accounting does not require the discounting of the value since the funds are not restricted and are immediately available. Superior was applying the cash-in accounting methodology to value the OC account even though the funds were not available to the institution upon collection. (Refer to Topics 2 and 5 for detailed discussions of the misapplication of FAS 125.)

A series of disagreements ensued among the federal banking regulators, bank management, and the external auditors, which was drawn out until January 11, 2001 when the issue was resolved. At that time, a national partner of E&Y decided that the regulators were correct in their assessment of FAS 125 and the institution and the regional partner of E&Y were incorrect in their interpretation and application of FAS 125.

E&Y revalued the OC account and residual interests. Based on a revaluation of the residual interests and their related accounts, Superior suffered extreme depreciation in these assets, which adversely affected the institution's capital level. The approximate adjustments for the two accounts totaled \$420 million, with a \$270 million reduction to the OC account and a \$150 million write-down to the residual interests. Based on the remaining business activities, Superior could not rebound from the deficient capital level it had sustained from the securitization activities.

Topic 2 - The levels of concentration and amount of valuation in residual interests held by Superior and the treatment of the residuals by OTS.

Once Superior began its securitization process, the levels of this activity expanded rapidly. From 1995 until the institution closed, concentrations of residual assets exceeded 100 percent of Superior's capital. The Office of Thrift Supervision (OTS) had an annual presence in the institution, with the exception of 1998, and conducted safety and soundness examinations each year. The OTS used capital markets specialists to review the securitizations beginning in 1996. Because of the external auditors' misapplication of Financial Accounting Standards (FAS) 125 and the institution's use of liberal assumptions to value the residual interests, the residual interests and the overcollateralization (OC) accounts were overvalued, which in turn overstated the capital of the institution. The valuation of the residual interests was questioned at the January 2000 examination. Once the overvaluation of the residual interests and the overstatement of the OC account were confirmed during the October 2000 visitation and the March 2001 examination, the true state of Superior's capital deterioration became evident.

Superior Bank Engages in the Securitization Business

Superior Bank adopted the securitization of residential mortgages to borrowers with non-conforming credit histories as its primary business after the incorporation of Alliance Funding Company, Inc. (Alliance), a former affiliate, as a division of Superior. The incorporation of Alliance as a division of Superior occurred on December 1, 1992. When Alliance was an affiliate of Superior, it specialized in originating, purchasing, and selling first and second home mortgage loans to non-conforming borrowers. Alliance operated through a network of 968 brokers located throughout the United States. The addition of Alliance as a division of the institution brought additional expertise and personnel to enable a rapid expansion in this market niche.

In 1994, Superior expanded its subprime¹⁶ securitization activities to incorporate subprime automobile lending and securitization. This activity was not pursued as aggressively as the mortgage securitization. Therefore, the total dollar volume from the automobile securitization activities was nominal in relation to the mortgage securitization activities.

¹⁶ The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

Although concentrations of residual assets¹⁷ were noted in Office of Thrift Supervision (OTS) Reports of Examination, in 1998 Superior began to rapidly expand its efforts in the subprime securitization market.

Residual Interests – A By-Product of the Securitization Process

Various types of financial instruments may arise as a result of the securitization process. One of these is a class known as residual interests. The residual interests represent claims on the cash flows that remain after all obligations to investors and any related expenses have been satisfied. The residual interests represent funds required to build reserves and pay loan losses, servicing fees, and liquidation expenses. Any excess money, after all expenses have been met, provides a return to the holder of the residual interests. When the loans for the pools originate, they bear a stated interest rate. The securitized instruments are issued to investors at a lower interest rate than the stated rate on the loans. The difference between the interest rate that the loans are earning versus what the securitized pools are paying to investors is called the residual interest. Residual interests may be retained by the sponsors of the securities or sold to investors in the form of securities known as interest-only strips. Superior retained the residual interests from its securitizations. The problems for Superior began when they amassed large quantities of these high-risk assets.

Accounting for Superior Bank's Securitizations

Because residual interests were not common in the financial markets, information on default rates, discount rates,¹⁸ and prepayment rates of securitizations consisting of subprime loans was not readily available for comparative purposes. Unexpected market events can dramatically affect the discount rates or the default rates, thereby affecting the value of the asset and impairing the collectability of the future income stream. The use of liberal and unsupported assumptions can result in inaccuracies in financial statements and require material write-downs of the residual interests.

Superior recorded the values of the residual interests using a cash flow model. The cash flow model was based on assumptions, including discount rates, default rates, and prepayment rates, that Superior made concerning the portfolio of subprime loans underlying the securitized assets. In the 1993 through the 1999¹⁹ Reports of Examination, the OTS did not take exception to the assumptions that Superior used since they appeared to be reasonable. However, following the January 1999 examination, Superior changed to more liberal assumptions. They lowered the discount rate used to

¹⁷ The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

¹⁸ A discount rate is an interest rate used to convert future receipts or payments to their present value.

¹⁹ This includes all years except 1998, which is excluded since the OTS did not perform an examination of Superior in 1998.

value the residual interests, which in turn increased the value of the asset. Also, the revised prepayment and loss rates were not consistent with actual performance. At the conclusion of the January 2000 examination, the OTS was highly critical of the high-risk lending activities and the liberal and unsupported assumptions used by the institution.

Besides the regulatory criticism relating to the liberal assumptions used to value the residuals, Superior encountered other accounting difficulties. The Federal Deposit Insurance Corporation (FDIC) participated in the January 2000 examination with the OTS. Several capital markets specialists were in attendance from both agencies. The examiners questioned whether the provisions of Statement of Financial Accounting Standards (FAS) 125 were applied correctly to the overcollateralization (OC) account. Because of the institution's clean audit reports from Ernst & Young (E&Y), the examiners relied on E&Y's conclusions. After the 2000 examination was completed, the institution's composite rating was downgraded primarily because of the high-risk lending program, the use of the unsupported liberal assumptions associated with the residual interests, and the potential overvaluing of the OC account, all of which could have had a negative impact on Superior's capital position.

The OTS and the FDIC returned to the institution in October 2000 for a visitation to determine management's compliance with the January 2000 report recommendations. It was at this visitation that the different perceptions of the valuation of the OC account between the examiners, E&Y, and the institution culminated. In September 1998, December 1998, and July 1999, the Financial Accounting Standards Board Special Report issued "Question and Answer" guidance on FAS 125. The information in the December 1998 and July 1999 guidance, specifically question No. 75, supported discounting the value of credit enhancements for the period in which the funds are restricted. According to the securitization agreements, the OC account was restricted and the funds were not immediately available to Superior. The OC account was to be released incrementally over the life of the securitization. Therefore, the OC account should be discounted to reflect this period in which the account balance was restricted and not available for Superior's use. This methodology is in keeping with cash-out accounting, which requires the discounting of the value until the funds are released to the entity. Conversely, cash-in accounting does not require the discounting of the value since the funds are not restricted and are immediately available. Superior was applying the cash-in accounting methodology to value the OC account even though the funds were not available to the institution upon collection.

After numerous discussions between the institution, the owners, the regulators, and the accountants, it was decided that the accounting methodology was incorrect and the OC account was overvalued. E&Y conducted an analysis of the account and determined that the OC account would require a material write-down of \$270 million to reflect the discounting that should have been applied in accordance with FAS 125. The residual interests also required a revaluation because Superior could not support their rationale for changing to more liberal assumptions. A substantial write-down of approximately \$150 million was required to reflect reasonable assumptions associated with the residual interests. The write-down in the OC account had a significant detrimental impact on Superior's capital position as of December 31, 2000 rendering Superior significantly

undercapitalized for PCA purposes. The write-down required for the overvaluation of the residual interests was never reflected in the Thrift Financial Reports (TFR) because the bank and OTS were anticipating the implementation of a recapitalization plan.

Concentration Level and Dollar Amount of Superior's Securitization Activities

The following table details the concentration levels of the residual assets as a percentage of capital and their dollar volume as of financial statement dates at various OTS examinations.

Table 1: Concentration Levels and Dollar Volume of Superior's Residual Assets

Financial Statement Date	Residual Interests as a Percentage of Capital	Dollar Volume of Residual Interests
6/30/95	100.01% (1)	65.8 million
6/30/96	142.00% (1)	148.2 million
9/30/97	147.40% (2)	225.2 million
12/31/98	167.04% (2)	360.4 million
12/31/99	348.09% (3)	905.3 million
6/30/00	345.43% (2)	977.3 million
9/30/00	337.76% (2)	952.8 million
12/31/00	1,638.00% (1)	707.2 million
3/31/01	2,042.20% (1)	841.8 million

Source: OTS Reports of Examination, OTS October 2000 Field Visitation Report, and March 16, 2001 off-site examination memorandum

(1) Indicates core capital²⁰

(2) Indicates tangible capital²¹

(3) Indicates equity capital²²

OTS's Treatment of Superior's Residual Assets

The residual assets were the credit enhancements that Superior was obligated to provide through the securitization agreements in order to achieve a particular rating to enhance the marketability of the securitized bonds. From the onset of Superior's subprime securitizations, the OTS examiners noted in their examination reports the increasing levels in the residual assets retained by Superior; however, the OTS rated Superior a composite "1" or "2" from 1993 through 1999 despite the growing amount of these high-risk assets. Table 2 indicates the examination dates and the CAMEL(S) ratings assigned by the OTS. In cases where the individual components were not available, only the

²⁰ Core capital includes tangible capital and qualifying intangible assets.

²¹ Tangible capital includes common stockholders' equity, additional paid-in capital, retained earnings, noncumulative perpetual preferred stock (less any contra accounts), pledged deposits, minority interests in the equity accounts of consolidated subsidiaries, and unrealized gains and losses on available for sale securities.

²² Equity capital includes perpetual preferred stock, common stock, additional paid-in capital, unrealized gains and losses on available for sale securities, retained earnings, and other components of equity capital.

assigned composite rating is listed. An intervening downgrade assigned by the FDIC is also reflected in Table 2.

Table 2: Examination Ratings for Superior Bank, FSB

Regulatory Agency	As of Examination Date	CAMEL(S) and/or Composite Ratings
OTS	3/28/91	2
OTS	7/20/92	2
OTS	7/6/93	2
OTS	8/8/94	2
OTS	9/11/95	2
OTS	6/30/96	2
OTS	10/27/97	2-1-1-2-1/2
OTS	1/25/99	2-2-2-1-2-1/2 *
FDIC	Off-site monitoring in the 2 nd Quarter of 1999	3-3-3-1-2-2/3
OTS	1/24/00	Final Rating: 4-3-4-2-2-1/4
FDIC	1/24/00	Final Rating: 4-4-4-3-2-1/4
OTS	3/19/01	5-5-4-5-4-4/5
FDIC	3/19/01	5-5-5-5-4-4/5

Source: OTS and FDIC Reports of Examination

* A sixth component, Sensitivity to Market Risk was added to the CAMEL rating. Refer to the Glossary for a complete definition.

The CAMEL(S) rating reflects the risks in financial institutions. Since Superior had such a large volume of high-risk assets, which affected every component of the CAMELS rating, a lower CAMEL(S) rating should have been assigned earlier to reflect this risk.

Treatment in the Early Years 1993 - 1999

As soon as Superior became involved in the securitization activities in 1993, the OTS examiners were expressing their concerns for the level of residual interests and the additional risks posed by these instruments and their underlying mortgages. The 1993 report indicated that of the \$10.87 million combined net income reported for the 6 months ending June 30, 1993, \$8.1 million was generated through the mortgage banking area. The OTS Report of Examination recommended that Superior's Board of Directors establish limits for the amount of residuals that the institution would retain as a percentage of capital in order to contain the risk in the mounting asset. Also, the 1993 report instructs management that the residual interests were reported inaccurately²³ on the Thrift Financial Reports (TFR).

During the 1993 examination, the OTS cautioned that Superior should develop a comprehensive dividend policy addressing the impact of both cash and payment in kind

²³ Superior listed the residual interests on the TFRs as derivative securities. The OTS stated that they should be shown on the TFR as excess mortgage servicing rights.

dividends on all capital levels, with and without the book value of the residual interests. No mention of this recommendation was noted in subsequent examinations. In a December 21, 2001 OTS response to an FDIC Office of Inspector General (OIG) letter requesting clarification on several issues, the OTS stated that at that time, the Board promised to review the dividend policy and make any necessary changes by December 31, 1993. The OTS reiterated the need for a dividend policy in a February 8, 1994 meeting with Superior's management, who again stated that its intent was to submit a current dividend policy. A review of the OTS files indicates that a new policy was not submitted. Instead Superior continued to adhere to a dividend based on 50 percent of net income. The OTS stated that Superior's computation of net income followed Generally Accepted Accounting Principles (GAAP.) Also, based on Superior's reported financial condition, the requested amounts of the dividend payments fell within the OTS regulatory rules.

In 1994, the OTS Examiner-in-Charge (EIC) cautioned Superior about the increasing levels of residual interests. The board still had not established specific limits for the amount of residual interests. Additionally, management did not address the recommendation in the 1993 OTS examination regarding correctly identifying the residual interests on the TFRs. As a result, Superior was still submitting inaccurate TFRs to the OTS because the residual interests were misclassified on the TFRs. The 1995 examination noted that the amount of the residual interests now exceeded 100 percent of capital.

One of the most significant issues raised during the 1994 and 1995 examinations was Superior's erroneous calculation of the Allowance for Loan and Lease Losses (ALLL). The inclusion of a percentage of the ALLL in supplemental capital for purposes of assessing the bank's capital position makes the accuracy of the ALLL critically important. Depending on the amount in the ALLL, all or a portion of the ALLL up to 1.25 percent of risk weighted assets, is allowed to be included in supplemental capital. Superior's ALLL was comprised of three individual pieces. One portion provided for loss contingencies in the retail banking division. A second piece covered the volume of loans originated, securitized, and sold in the mortgage banking unit. The third piece was a valuation established to protect the institution from the devaluation of the residual interests due to fluctuations in the business cycle. The OTS Examiner-in-Charge (EIC) criticized Superior's inclusion of the third portion in the ALLL since it was not established because of credit conditions and should therefore be excluded from the ALLL. Because this portion was included, the ALLL was overstated which in turn overstated the capital level. Despite the second admonishment in 1995 for including erroneous amounts in the ALLL, Superior did not take affirmative action to correct the inaccuracies. No further mention was made of the inclusion of the inaccurate valuation amounts in the ALLL until the 2000 examination when massive adjustments were made to the account. The ALLL was detailed in the ensuing reports (1996 – 1999); however, the examiners did not mention or criticize the inclusion of erroneous valuation amounts. In the December 21, 2001 response from the OTS to the FDIC OIG concerning this issue, the OTS stated that at that time there was little guidance concerning the activities in which Superior was involved. According to the risk-based capital guidance, the loans

underlying the securitizations were required to be converted as if they were on-balance sheet equivalents. Because of this requirement, the OTS viewed the converted²⁴ off-balance sheet loans and the ALLL as if they were both items on the balance sheet at Superior. Future implementation guidance of FAS 125 issued in July 1998, December 1998, and July 1999 provided clarification on the accounting issues. At the January 2000 examination, it became clear to the OTS that the residual assets should be carried at fair value without the support of a reserve. At this time, Superior was required to net the interest rate risk and credit risk components of the reserve against the residual assets for TFR reporting purposes and exclude the remainder of the ALLL attributable to the residual assets from the risk-based capital calculations.

The OTS conducted an intensified examination of the securitization process in 1996. The OTS Washington Office enlisted the assistance of a capital markets specialist from the OTS Southeast Region to conduct the review of this area. The examiner thoroughly reviewed Superior's assumptions, which were used to establish valuations for the residual interests. At the conclusion of the examination, the OTS examiner stated that the valuations seemed reasonable, and no criticisms in this area were noted in the Report of Examination. The 1997 and 1999 examinations showed similar results. The regional capital markets specialists reviewed the securitizations and nothing extraordinary was noted. Overall, the EIC of both examinations indicated that no material supervisory concerns were noted and that overall risk management practices were satisfactory. The major concern was the level of the residual assets in relation to capital; however, the examiners' stated that their concerns were mitigated by strong capital levels. The 1997 and the 1999 reports, as well as subsequent correspondence did not indicate that the OTS took any actions to restrain Superior's level of residual interest assets.

After receiving and reviewing the OTS Report of Examination dated January 25, 1999, the FDIC believed that the OTS's composite rating of "2" was not representative of the risk posed by the institution. The FDIC evaluates the examination reports that are submitted by the other banking agencies to determine if the ratings reflect the risk in the institution in order to reduce potential losses to the funds. Because of the risk in Superior's securitizations, the level of repossessions, and the residual assets' inordinate size in relation to capital, the FDIC downgraded Superior to a composite "3" for risk-related insurance premium purposes. The OTS did not agree with the downgrade. The OTS thought that the FDIC's reasons for downgrading the rating were unsupported; therefore, the OTS thought that the rating change was too harsh.

Following the 1999 examination, Superior liberalized its assumptions for valuing the mortgage-related residual interests, thereby, increasing the value of the residuals.

Treatment in the Latter Years 2000 - 2001

The FDIC participated with the OTS in the 2000 examination. Numerous flaws were noted with the altered assumptions for valuing Superior's mortgage related residual

²⁴ This is a method used in the calculation of risk-weighted assets whereby the off-balance sheet items are multiplied by a risk factor that converts or transforms the risk into a balance sheet equivalent.

assets. There was no documentation, such as comparable industry figures, to support the newly implemented assumptions. The concentration of residual assets was escalating and the board had still taken no action to curtail the amount of residuals acquired by the institution. The OTS advised the board to adopt restrictions on the amount of residuals in relation to the capital protection. Additionally, adverse classifications attained an excessive level because of the high-risk lending program. Policies, including the classification and ALLL, needed revamping to include all significant institutional activities.

In 2000, the OTS recommended that management implement procedures to determine the fair market value of the residual interests and adjust the carrying values of these assets accordingly, since it appeared that write-downs might be necessary due to the use of the unsupported assumptions. The examiners from both agencies questioned the accounting associated with the OC account. A DOS examiner stated that the OTS was reassured by management that E&Y had expressed an unqualified opinion in the firm's audit reports, which included information pertaining to the accounting methodology for the OC account. Because of E&Y's clean audit reports, examiners from the FDIC and the OTS relied on E&Y's assessment of the validity of the OC account.

Also, the ALLL was grossly overstated due to the inclusion of valuations for the residual assets. The value of the ALLL was reduced from \$128 million to \$2.6 million at the conclusion of the 2000 examination to exclude ineligible funds that were in the ALLL. Additionally, the 2000 report disclosed that Superior was still incorrectly reporting the residual assets in the TFR. At the conclusion of the examination, Superior was accorded a composite rating of "4."

On July 1, 2000, because of the concerns noted at the January 2000 examination, the FDIC downgraded Superior to a category "C" for risk-related premium purposes. The OTS concurred with the reclassification. On July 5, 2000, the OTS issued to Superior a Notice of Deficiency and Requirements for Submission of a Part 570 Safety and Soundness Compliance Plan. The Part 570 directive was issued based on the results of the 2000 examination. The Part 570 directive required a plan outlining procedures for the revaluation and sensitivity testing of the residual assets. It also included provisions for the internal control function, credit underwriting standards, and the revision of the ALLL policy, including procedures to maintain the ALLL at a level commensurate with the risks at the institution. The directive also required Superior to formulate a plan to reduce its investment in residual assets to 100 percent of Tier 1 leverage capital within a year. This is the first documented evidence since the recommendation made in the 1994 OTS examination that the OTS placed any limitations on the extent of Superior's maximum involvement in residual assets. Superior submitted the compliance plan to the OTS on August 4, 2000.

To confirm whether Superior had implemented corrective measures stemming from the January 2000 examination report, the OTS scheduled a visitation in October of 2000 with FDIC participation. After reviewing the information on the OC account, both agencies determined that the accounting methodology was not correct and that the account was

overstated. E&Y and Superior's management disagreed with the examiners' assessment that the account was incorrectly stated. This was the beginning of a several month long controversy which was ultimately resolved by E&Y's New York National Office which agreed with the regulatory agencies in January 2001 that the accounting for the OC account was incorrect and adjustments were necessary to reflect the correct total.

The OTS, with FDIC participation, conducted an examination on March 19, 2001. Superior ceased its securitization activities and gain on sale accounting associated with the mortgage division on June 30, 2000. Because of the high level of risk and the disproportionate size of the residual assets in relation to capital, the examination focused on the residual assets that remained on the institution's books. After E&Y's New York Office agreed with the regulatory authorities, a \$270 million write down was required to adjust the value of the OC account. This dropped the institution from its former status as a well and/or adequately capitalized institution to a significantly undercapitalized institution. Further, Superior was still unable to provide documentation to support the assumptions used to value the residual interests. The examiners calculated that additional write-downs of approximately \$150 million would be required as of December 31, 2000.

Because of the required year-end adjustments for the OC account, but prior to the adjustment for the overvaluation for the residual interests, Superior was designated as "significantly undercapitalized" for PCA purposes. The OTS issued a PCA Directive to Superior on February 14, 2001 and a consent Cease and Desist Order to two of the holding companies, Superior Holdings, Inc. and CCFC, as of the same date. Superior was required to submit a Capital Plan by March 14, 2001. Superior met the deadline; however, the OTS did not consider the plan acceptable.

Capital problems resurfaced at the end of the first quarter of 2001 when expenses from discontinued operations threatened to lower Superior's capital designation to "critically undercapitalized." In April 2001, retroactive to March 31, 2001, CCFC injected \$81 million in residual interests in order to avoid any further decline of Superior's capital level. This "injection" of residual interests further increased the holdings of Superior's residual assets and kept the institution above the critically undercapitalized benchmark for PCA purposes. The OTS responded to the FDIC OIG's questions regarding this issue in OTS's written response dated December 21, 2001. The OIG inquired why the OTS permitted Superior to count the residual interests towards their capital when the OTS Handbook specifically states that the inclusion of non-cash contributions as a source of capital is not an acceptable practice. The OTS responded by stating that the transaction was in conformance with GAAP. According to the OTS response, the OTS Handbook is only meant as guidance and is not an authoritative source; therefore, deviations from the handbook must be analyzed on a case by case basis. The contributed residual interests were part of Superior's proposed Capital Plan. Under the plan, the residual interests would be purchased from Superior by a special purpose vehicle. The residual interests would be converted into cash within 60 days of the Capital Plan's approval date. Therefore, the OTS did not disapprove the transaction.

Additionally, contrary to accounting standards, Superior netted certain assets and liabilities in order to reduce their totals, which in turn assisted in increasing their tangible capital ratios above the 2 percent threshold. The OTS responded to the FDIC OIG's questions regarding this issue in their written response dated December 21, 2001. In correspondence dated May 3, 2001, the OTS questioned whether Superior was using the right of setoff²⁵ properly. The examiners from both the OTS and the FDIC were to review this issue during the 2001 examination. An OTS memorandum indicated that it was unlikely that Superior should have used the right of setoff when filing the March 31, 2001 TFR. However, prior to any final determination on this issue, the OTS approved Superior's Capital Plan. At this time, the OTS's choice was to either implement the Capital Plan or place Superior into receivership. The OTS considered the right of setoff issue "somewhat moot."

The Capital Plan that the OTS conditionally accepted stated that the residual assets would be purchased by the holding company through a series of transactions including cash injections from the owners, third party financing, and the pledging of bank assets. The OTS did not require Superior to write down the value of the residual interests during the 2001 examination since the plan listed the sale price of the residual assets as \$10 million over the book value. Additionally, the OTS did not require Superior to restate its March 31, 2001 TFR, which listed the residual interests at amounts exceeding their true value.

Other adverse examination findings in the March 2001 examination included out of balance accounts, an unsecured receivable from Superior's second tier holding company²⁶ and required reductions to servicing assets. The out of balance accounts consisted of two accounts entitled "Other Receivables." The first account consisted of deficiency balances on auto loans after disposal of the autos, plus losses on the sale of repossessed autos. Some of the items dated back to November 1999. The total loss in this account was \$3.4 million. The second account consisted of an unreconciled difference from another general ledger account involving principal and interest advances on securities. The total loss on this account was \$4.6 million. Beginning in April 1999, Superior had transactions with its second tier holding company, CCFC. At the 2001 examination, it was discovered that Superior had a receivable on its books from CCFC for \$36.7 million. Superior sold loans to CCFC. CCFC in turn sold these loans for a \$20.2 million profit. The bulk of the \$36.7 million balance represented profits from the sale of loans by CCFC that were owed to Superior. The OTS listed this receivable as a violation between Superior and CCFC for engaging in transactions that were not at arms length and for extending unsecured credit to an affiliate. Lastly, Superior had advances related to six closed securities that should have been written off. The securities were called as of April 30, 1999 and Superior, as servicer, failed to collect the advances

²⁵ The right of setoff issue evolved from the sale of certain mortgage loans that were purportedly under commitment for sale to various financial intermediaries. FASB Interpretive Opinion No. 39 sets requirements in order to establish the right of setoff. The effect of the setoff is the reduction of certain assets by the corresponding amount of liabilities. This in effect, reduces the total assets and liabilities.

²⁶ CCFC transferred ownership of Superior to Superior Holding, Incorporated (SHI), which became Superior's first tier holding company. CCFC owned SHI and CCFC became Superior's second tier holding company.

totaling \$4.9 million due from the trust. Additionally, the OTS criticized the unprofitable status of the institution.

According to the FDIC's draft March 19, 2001 Report of Examination, if all of the losses noted at the examination were charged-off and all adjustments were made, the institution was insolvent as of that examination. Because of the ongoing negotiations with the owners concerning the capital restoration plan, the OTS did not require Superior to charge-off the \$150 million revaluation of the residual interests. The FDIC 2001 draft report was not finalized and remitted to the institution.

OTS Treatment of the Residuals - Subprime Automobile Loans

Superior expanded its market in subprime loans with the addition of subprime automobile lending in 1994. The first OTS exam after this business line became fully operational was conducted in 1997. This examination criticized management for omitting delinquent auto loans and repossessions in their TFRs.

At the 1999 examination, the OTS noted that the auto division had an unacceptable level of delinquencies and losses. Once again, management was criticized for excluding assets, which should have been listed as adversely classified assets on the TFRs. The OTS required Superior to establish specific valuation reserves for loss classifications totaling \$12.5 million. The OTS recommended that management amend the classification system to ensure accurate regulatory reporting and establish all appropriate allowances. Additionally, the OTS recommended that Superior revise and expand the ALLL policy to cover all of the pertinent business of the institution.

The FDIC participated in the 2000 examination with the OTS. Adversely classified assets and higher than anticipated loss rates, which were more than double the original estimates, continued to mount in the automobile division. Superior was instructed to follow the *Uniform Credit Classification and Account Management Policy*, which had been adopted by all of the federal banking regulators.²⁷ (Refer to Topic 5 for additional information on the OTS's lack of enforcement of the requirements of this policy's guidelines at previous examinations.) The OTS also charged-off a \$12 million asset swap between Superior and Western Trading, an advertising concern. Superior "sold" worthless auto loans, which should have been charged-off, for future advertising credits. Despite tightening lending standards twice and reducing the lending volume, the auto division was not profitable. The OTS again criticized management for incorrectly risk weighting assets associated with the automobile division for purposes of calculating risk-based capital. Superior's unsuccessful subprime automobile lending operations ceased in December 2000. Expenses associated with the disposition of this division continued to impair income in 2001.

²⁷ This policy was adopted by the OTS in 1987. However, OTS examiners in 1999 and 1997 did not use the policy to classify loans at Superior that fell within the scope of this policy. The OTS did not require Superior to follow the policy until the 2000 examination.

Topic 3 - The regulator's reliance on and oversight of accounting information provided by the institution and its external auditors.

The Office of Thrift Supervision (OTS) did not independently determine the value of Superior's residual assets – residual interest and overcollateralization accounts – or take enforcement action when its examiners found errors in Superior's Thrift Financial Reports (TFR). Instead, OTS relied on Superior's management and its external auditor, Ernst & Young (E&Y) for the valuations of significant assets. The OTS placed undue reliance on the unqualified opinions that E&Y gave on Superior's annual audited financial statements. Because of the high-risk nature of subprime²⁸ lending – Superior's principal line of business – OTS should have more closely scrutinized the value of Superior's residual assets and conducted more frequent reviews of E&Y's workpapers. In addition, OTS should have required Superior to file corrected TFRs when material errors were found, and taken enforcement actions against Superior and its management when Superior continued to file erroneous TFRs.

Reliance on and Oversight of Superior's External Auditor

Superior management, with the advice of its external auditor, Ernst & Young (E&Y), utilized accounting practices that made the institution appear more profitable than it was. This, in turn, enabled Superior to make substantial dividend payments in accordance with its dividend policy, take on more risk in the form of additional securitizations and deflect regulatory concern by holding out its overstated capitalization ratios and additional profitability. E&Y, the bank's external auditor from 1990 through 2000, gave Superior unqualified audit opinions and did not question the valuations or calculations involving Superior's assets and capital structure. Ultimately, in 2000, the OTS and the FDIC examiners questioned the incorrect calculation of the overcollateralization account and the valuation of the residual interests. After the January 2000 OTS examination, but before ceasing securitization activities on June 30, 2000, Superior increased the amount of risk in these assets.

E&Y Advised Superior's Audit Committee

According to minutes from an Audit Committee Meeting of Superior's Board of Directors held on January 27, 2000, E&Y's Engagement Partner (E&Y Partner) gave a summary of the audit results completed for the fiscal year ended June 30, 1999. E&Y Partner presented a package to the Audit Committee that identified E&Y's: audit

²⁸ The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

approach, areas of audit emphasis, required communications, next fiscal year's audit approach, summary of emerging technologies and related risks, an overview of the audit process, and a summary of audit differences. The E&Y Partner went through each area identifying key points during the audit process. He also noted the various reports that were issued by E&Y as a result of the audit process and that all such issued reports contained audit opinion letters, which noted no exceptions.

Subsequent to the presentation by E&Y's Partner, a detailed discussion relative to financial receivables²⁹ (a/k/a residual interests) and the audit steps performed during the review processes by E&Y ensued between E&Y's Partner and an Audit Committee member. E&Y's Partner explained in detail the audit process and the testing techniques that E&Y utilized to evaluate the underlying assumptions and the model utilized by the bank. He also detailed that the firm's audit processes included a review of the bank's balance sheet carrying values of financial receivables and related assets, recoverability analysis of financial receivables, and the related income statement accounts. According to the January 27, 2000, meeting minutes, E&Y's Partner noted that, "E&Y had an overall comfort with the assumptions utilized by the Bank and the resulting values." E&Y's Partner noted that after running the firm's own model with varying assumptions to test the bank's model, "E&Y believes that the overall book values of financial receivables as recorded by the bank are reasonable considering the bank's overall conservative assumptions and methods." Clearly, as of June 30, 1999, E&Y concurred with the assumptions and the model used by Superior management to value the financial receivables.

Next, the Audit Committee and E&Y's Partner entered into a discussion relative to Statement of Financial Accounting Standards (FAS) 140 (FAS 140 replaced FAS 125³⁰ and became effective after March 31, 2001), which would be required to be utilized by the bank for the fiscal year 2001. It was noted that the primary effect of FAS 140 on the bank would be that it would require the bank to provide greater disclosures of the accounting assumptions it used to record the book value and related income of the financial receivables. The disclosure would require a comparison to actual results achieved, such as Constant Prepayment Rate (CPR)³¹ speeds, discount rates, and loan loss reserve rates. According to the minutes, the bank's current model used a higher discount rate at inception and the ARM loan portfolio did not estimate the effect of using

²⁹ Financial Receivables is a term used by E&Y to describe a financial component of Superior's securitization transaction. Financial receivables, also known as residual interests in collateralized mortgage obligations, represent the net present value of future cash flows of the bank's residual interests from sales of loans over the estimated life of the loans. Expected net cash flows would be reduced to reflect adjustments for estimated prepayments, losses, and discounts at rate management believes to be similar to a yield required by a third party investor.

³⁰ FAS 125 was effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996 through March 31, 2001. FAS 140, a replacement of FAS 125 although most of its provisions are carried over into FAS 140, took effect after March 31, 2001.

³¹ CPR = Constant Prepayment Rate. The percentage of outstanding mortgage loan principal that prepays in one year, based on the annualization of the single monthly mortality, which reflects the outstanding mortgage loan principal that prepays in one month.

a prepayment ramp³² on the ARM portfolio. It was also noted that the overall discount rates being utilized by Superior, considering all factors, were comparable to current market discount rates used by other third parties.

In further discussing Superior's "conservative methods," E&Y's Partner noted that, "CPR factors, discount rates, loan prepayment fees and other conservative factors used by Superior may need to be reviewed and potentially adjusted to reflect current market factors to more closely track actual results under reporting required by FAS 125." Immediately following the Partner's caution were unattributed statements that implied that Superior did not have to worry about the impact of FAS 140 disclosure requirements. The minutes state, "However, it was further noted that based on an initial review, changes in these factors and methods would result in offsetting changes in reported values. Confirming the factors and methods used to facilitate the disclosure requirements of FAS 125 would likely result in the use of different assumptions without substantially changing the initial valuation recorded by Superior." We could not determine from reviewing the minutes whether E&Y's Partner or one of Superior's board members made the two statements.

As of January 27, 2000, E&Y took the position that Superior's accounting methodology and valuation assumptions for its financial receivables were in conformance with Generally Accepted Accounting Principles (GAAP) but might be impacted by FAS 140, which required additional disclosures in the financial statements.

OTS Reviewed E&Y's Workpapers

OTS's Regulatory Handbook, Section 350, Independent Audit, issued August 16, 1995, provides guidelines for examiners about the use of the external auditor's annual work. The annual external audit should be used to assist in the financial analysis of institutions to identify areas of supervisory concern or accounting complexity and to detect trends and information not otherwise revealed in the monitoring of institutions. The independent auditor performs procedures that evaluate the reliability of financial statement assertions and certain assertions included in the Thrift Financial Report (TFR). According to the AICPA's Statements on Auditing Standards (SAS), specifically SAS No. 31, Evidential Matter, audit objectives are established to test the numerous assertions (both implicit and explicit) that are included in a client's financial statements. These assertions can be grouped into the following five categories: existence and occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure.

Section 350 states that examiners should use the annual audit to supplement the examination process whenever possible. Examination personnel are encouraged to review the audit workpapers when planning examinations. The review is intended to help determine the scope of the examination, identify areas where examination procedures can

³² The term is a concept often used with home equity loans and manufactured-housing transactions to describe a series of increasing monthly prepayment speeds, prior to a plateau, on which the expected average life of a security is based.

be supplemented by audit work, identify audit work that can be relied on for certain financial statement assertions, and identify high-risk areas that require expanded procedures. Examiners may rely on the audit work findings in low-risk areas. In such cases, examiners should request that the auditor provide copies of the key workpapers. In high-risk areas, examiners should use the audit evidence to plan and supplement examination procedures. Examiners should also consider exercising the OTS's authority to direct auditors to perform specific or additional audit procedures. In such cases, the regional accountant should be consulted.

OTS relied on accounting information provided by the bank and validated by E&Y. Not until the January 2000 examination and subsequent October 2000 field visitation did it become apparent to OTS that it may have relied too heavily upon Superior management's financial statements and E&Y's unqualified audit opinions of those financial statements. OTS did not detect the uncertainties over the accounting treatment accorded to Superior's residual interests and overcollateralization (OC) account early enough to correct the problem before Superior failed.

According to the OTS Chicago Regional Accountant, examiners conduct reviews of external audit workpapers to help them scope their examination and focus on the higher risk areas present in an institution. Examiners also try to eliminate areas or reduce the amount of work they would ordinarily do after determining the extent to which the external auditor conducted its audit. His explanation was in concert with Section 350 that states that after reviewing the auditor's workpapers, the examiner may decide to do some or all of the following:

- 1) reduce the scope of the examination in certain areas based on the extent, scope, and findings of the audit;
- 2) expand the examination scope in certain high-risk areas based on the audit work;
- 3) expand the scope in certain areas based on the auditor's findings that disclose matters of supervisory concern; and,
- 4) refer regulatory reporting issues to the regional accountant.

Section 350 provided the following examples of cases where a review of the audit workpapers and conversations with auditors could assist examiners in performing examinations.

- 1) An association has asset quality problems and reserves are deemed by the auditor to be adequate. The audit workpapers document management's valuation estimates and indicate the audit procedures performed to test those estimates. After the review, the examiner would understand management's approach and the exposure areas.
- 2) An association has aggressive accounting practices. The audit workpapers would document management's reasons for the aggressive practices. After the review, the examiner would understand management's rationale and could assess whether a less aggressive accounting practice would be more appropriate from a safety and

soundness standpoint.

- 3) An association has serious internal control problems. The full extent of the problems should be discussed with the auditor to determine where the scope of the examination should be expanded.
- 4) An association has mortgage servicing assets. The audit workpapers would document the assumptions and methodologies used to value the servicing. If the findings are acceptable for safety and soundness reasons, the examiner could rely on the audit work.

Of the four examples cited above, Superior exhibited characteristics cited in virtually all four examples. According to Section 350, a review of the audit workpapers and a discussion with the auditor in each of the above examples would likely improve the examiner's understanding of the differences in judgment or fact that might require examination adjustments to the TFR. They also illustrate how the examiner can focus scarce examination resources on problem areas by using some of the evidence gathered by the auditor.

OTS performed workpaper reviews in conjunction with the 1996 and the 2000 examinations and subsequent 2000 field visitation. During the 1996 workpaper review, OTS focused on Superior's financial receivables. However, information was not available that addressed the scope and procedures performed by OTS to determine whether E&Y's work could be relied upon, and the OTS was not critical of E&Y's 1996 workpapers. The workpaper review performed by the OTS and the FDIC examiners in conjunction with the October 2000 visitation helped lead to the discovery of the incorrect accounting treatment for Superior's OC account. The eventual restatement of the OC account was one of the major factors that ultimately led to the closing of this institution.

January 2000 Examination

During the January 2000 examination, a meeting involving the examiners from the OTS, the Federal Deposit Insurance Corporation (FDIC), and E&Y representatives (current and former partners assigned to Superior) provided a more in-depth review of the financial receivables (a/k/a residual interests) area including work performed in completing the E&Y's June 30, 1999, audit of Superior's financial statements. Topics discussed included the institution's escrow methodology, fair value assessments, E&Y's independent modeling, and various other financial receivables related areas. Examiners learned that valuation modeling work was completed by E&Y's Structured Finance Services Group. E&Y's partners advised that E&Y took a global approach in judging this area. An individual fair value calculation of each financial receivable was not performed. Instead E&Y completed a macro analysis to verify reasonableness of the financial receivables net book value and valuation model used by Superior's affiliate,

Fintek.³³ Subsequent to these discussions, the OTS and the FDIC examination teams completed a review of E&Y's workpapers that focused on the extent to which E&Y provided an independent review of the modeling process and fair value recordation.

The examiners workpaper review revealed that E&Y's independent review of the modeling process and fair value recordation process was less than what the examiners anticipated. E&Y performed a limited review and verification of financial receivables fair values as of June 30, 1999, both on an individual and aggregate basis. Following the workpaper review, the examining teams focused their examination work on two primary areas: (1) Superior's recordation of gains and financial receivable analyses and (2) impairment analysis. The teams' in-depth focused examination work revealed that:

- In E&Y's opinion, the balance of the financial receivables appeared reasonable. E&Y indicated that Superior used value assumptions that differed from other securitizers due to its attempt to build-in certain "cushions" to "conservatively" book gains and carrying values. OTS concluded that Superior management's use of a cushion (excess market value over book value) was not supported in Superior's valuation of the financial receivable assets. To derive its own "reasonable outcome" and "conservative" assumptions to be used in E&Y's Structured Finances Services Group's modeling of Superior's gain-on-sale, E&Y used the results of a market survey from recent public offerings (over the period of June 1998 to December 1998). E&Y's work was limited to only one securitization, 1999-1. E&Y concluded that based on this information the value recorded for 1999-1, although on the high end of the range, was reasonable and supportable. At the time of E&Y's audit, Superior had 23 quarterly securitization transactions on its books as of June 30, 1999. Examiners were not comfortable with this minimal coverage given the concentration of financial receivable assets at Superior and the fact that the market survey was 6-12 months old.
- E&Y opined that the 11 percent discount rate used by Superior to value its financial receivable assets was an appropriate estimate based on a survey it conducted of Securities and Exchange Commission (SEC) reports of six publicly held companies that record this type of asset. Superior did not provide adequate support for its use of an 11 percent discount rate in the revaluation of its financial receivables assets. The support provided by Superior was dependent upon the analysis performed by E&Y at the June 1999 audit. E&Y stated that the data it used to determine this rate was from 6 to 12 months old as of June 30, 1999. This data stemmed from the period June 1998 to December 1998, a time when the general level of interest rates was at a historical low. Since the Treasury yield curve on constant maturities of from 2 to 10 years rose between 171 and 180 basis points during 1999, examiners believed the use of the 11 percent discount rate might understate the actual interest rate being used at December 31, 1999 by firms that record this type of asset. Superior attempted

³³ Fintek, Inc., was an affiliate of Superior that managed securitization activities. Fintek modeled cash flows, prepayments, and overall asset-backed structures for Superior.

to provide support for the 11 percent discount rate but failed to do so during the examination.

- E&Y evaluated whether the use of the OC structure as a reserve account impacted fair value given the FAS 125 Q&A Special Report³⁴ requirement that reserve accounts should be considered as residual interests and that the “cash-out” method (versus “cash-in”) is required for determining fair value. E&Y and Superior management contended that the cash-in and cash-out methods produced similar results because in Superior’s OC structure (more fully explained under Topic 4 in this report), cash is made available each month as received by the trustee. E&Y contended that in Superior’s securitization structure, there was no need to discount the OC assets and no need to model the valuation of the OC account because the asset was pledged to Financial Guaranty Insurance Company (FGIC) and was an owned asset of Superior, and not the trustee. The January 2000 OTS examination report was not critical of E&Y’s view of the OC account.
- E&Y’s overall conclusion about Superior’s impairment analysis was that it appropriately considered and responded to Superior’s prepayment experience through the financial receivable asset revaluation process. E&Y reviewed Superior management’s impairment measurement (re-runs of a cash flow model from day 1 with revised assumptions) and expressed concern as the methodology deviated somewhat from the approach dictated by GAAP. Notwithstanding, E&Y selected only one securitization series, 1996-4 ARM, for testing the institution’s impairment analysis. Overall findings of this review deemed the impairment assumptions to be reasonable for determining the fair value of the 1996-4 ARM. E&Y opined that the balance of the financial receivable assets at June 30, 1999 appeared reasonable. The examiners considered E&Y’s review to be superficial.
- E&Y did not perform a documented validation of the model used by Superior’s affiliate, Fintek, to value Superior’s financial receivable assets. Examiners were concerned with Superior’s outstanding exposure levels and current methodologies, and that an affiliated financial consultant company, Fintek, performed the modeling functions off-site. The examiners expected a periodic independent validation to assess model risk would have been part of a sound securitization risk management program.

From June 30, 1997 through June 30, 1999, E&Y went on record with opinions that Superior’s financial receivables appeared reasonable. OTS only performed reviews of E&Y’s FY 1996 workpapers in 1996 and E&Y’s FY 1999 and 2000 workpapers in 2000.

³⁴ In December 1998 and July 1999, the Financial Accounting Standards Board (FASB) issued Special Reports, “*A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Second Edition.*” Special Report Question #75 specifically addresses fair value determination of credit enhancement assets.

The January 2000 OTS report of examination was critical of Superior's valuation assumptions. Following the 2000 examination, Superior engaged E&Y on May 12, 2000, to conduct a Special Engagement review of its valuation and impairment measurement methods partly because of the examination results and partly because the bank had revised its methodology in reaction to the issuance of an "Interagency Guidance on Asset Securitization Activities" by the federal banking authorities. E&Y's engagement letter dated May 9, 2000, stated that E&Y was engaged to assist Superior in evaluating the implications and results of altering the bank's current method of establishing assumptions key to the calculation of the present value of financial residuals resulting from the securitization and sale of mortgage loans. The results of this engagement were not available until October 10, 2000, and will follow in chronological order.

In the meantime, on August 22, 2000, the OTS Chicago Regional Accountant placed a telephone call to E&Y's Regional Partner to discuss the accounting for the residual assets (i.e., residual interests and OC account) at Superior. The purpose of the call was to specifically inquire whether Superior was applying the cash-out method correctly and whether the rate paid to the investor was the appropriate discount rate to use for the OC account. It was not clear from the regional accountant's notes that an answer to his inquiry about the cash-out method and discount rate was provided by E&Y's Partner. However, the notes state that the OTS Chicago Regional Accountant suggested to E&Y's Partner that he run his inquiry by his national office (E&Y's Professional Practice Group in its New York National Office) before E&Y issued its June 30, 2000, audit report. The E&Y Partner did not agree or disagree to do this. Instead, E&Y's Partner raised an issue about the composite CAMELS "4" rating issued by OTS after its January 2000 examination and its impact on E&Y's opinion. According to the regional accountant's notes, the E&Y Partner would have to issue a "going concern opinion" because of the composite CAMELS "4" rating and concern that Superior could be taken over by regulators. The OTS Chicago Regional Accountant suggested that E&Y's Partner contact OTS to discuss the rating before the Partner issued a qualified opinion. According to the OTS Chicago Regional Accountant, no meeting was ever held to discuss these issues prior to E&Y's issuance of the June 30, 2000 audit report. E&Y issued an unqualified opinion on Superior's financial statements September 22, 2000.

On September 28, 2000, E&Y issued a memorandum on Financial Receivables in conjunction with E&Y's annual audit. The memorandum followed the issuance of E&Y's Report of Independent Auditors, dated September 22, 2000.³⁵ According to this memorandum, Superior had adopted and implemented a revised methodology to calculate fair value or the residual cash flows in FY 2000. The purpose of the change in the estimation process was to remove all "cushions" and to adopt a methodology and related valuation assumptions, which were independently verifiable. During its financial receivables review, E&Y analyzed the key features of the revised methodology, most notably, the discount rate, prepayment speeds, and credit losses. E&Y also addressed the "cash-in" versus "cash-out" method of accounting. E&Y's opinion memorandum concluded, "In our opinion, the balance of financial receivables at June 30, 2000 appears

³⁵ The September 22, 2000 report is E&Y's audit opinion letter with the accompanying financial statements.

reasonable.” This opinion reflected the conclusions found throughout the memorandum, as follows:

- **Discount rate:** The Financial Receivables memorandum concluded that Superior’s methodology resulted in a reasonable discount rate and was responsive to the characteristics of the underlying loan pool and applicable environmental factors, if applied in accordance with the methodology. In reaching the conclusions about the discount rate and paragraph 43 of FAS 125, the memorandum states that E&Y’s auditors consulted with the firm’s Professional Practice Group (meaning its New York National Office) and Structured Finance Services Group.
- **Prepayment speeds:** Superior developed a methodology to set projected prepayment speeds consistent with the characteristics of the loan pool or sub-pool. Appropriately, the characteristics were evaluated based on the characteristics of the loans remaining in the pool at the time of the valuation in order to recognize that the characteristics of the pool changed over time. E&Y concluded that the methodology was responsive to changes that occur in the make-up of the loan pool throughout the life of the pool. E&Y concurred with the change in Superior’s estimation process for establishing a forecasted prepayment speed for the loans in the underlying loans in the pools.
- **Credit losses:** E&Y found that Superior’s data for determining credit losses provided support for anticipated decline in future credit losses as compared to historical results of pools of loans originated in prior years. This data was used to establish forecasted credit loss estimations. Due to the limited loss history for the FY 1999 and FY 2000 pools, E&Y was unable to conclude as to the effect that Superior’s data would have upon credit losses. However, based on the magnitude of the effect of the characteristics noted and the shift in the make-up of the pools for FY 1999 and 2000 versus prior year pools, E&Y stated that an anticipated reduction in credit losses of 25 percent would not be unreasonable.
- **Cash-in vs. cash-out method of accounting:** E&Y offered the same arguments as delineated above during the workpaper review. E&Y contended that the cash-in and cash-out methods produced similar results because in Superior’s OC structure, cash was made available each month as it was received by the trustee. E&Y contended that in Superior’s structure, there was no need to discount the OC assets and no need to model the valuation of the OC account because the asset was pledged to FGIC and was an owned asset of Superior, and not the trustee.

On October 10, 2000, E&Y conveyed the results of the procedures enumerated in its May 9, 2000 engagement letter. The procedures were established through discussions with Superior’s Board of Directors, the Audit Committee, and other advisors. The procedures were performed in conjunction with and in addition to other procedures performed as part of the annual audit of Superior, as of and for the fiscal year ended

June 30, 2000. The nine procedural steps and E&Y's findings and conclusions were enumerated in a report to Superior's Board of Directors. E&Y's procedures are presented below in bold print and are followed by E&Y's findings.

Research and collect information relative to methodologies and disclosures used by other securitizers in the market.

E&Y researched available information contained in public documents, primarily Forms 10K and 10Q as of December 31, 1999 or March 31, 2000, and information prepared and distributed by Morgan Stanley Dean Witter, Prudential Securities, and Merrill Lynch & Co. This research covered over 20 companies. Greater reliance was given to reported information relative to entities that appeared to be operating freely and with a sound financial position. A review of this information provided sufficient evidence to indicate that the unique business risks of each institution was the prime driver of the methodologies used to value financial receivables. Further, the usefulness of the data was limited by the extent of information disclosed by each entity, which also varied. Most useful of the information extracted was information related to the discount rate applied to future cash flows in the valuation process, which is discussed below.

1) Evaluate pricing of various trust issued debt securities and evaluate correlation to methodologies and disclosures, if any.

E&Y wrote that the information listed above (item 1 above) resulted in the conclusion that there is diversity in disclosure information and pricing and, as such, no clear consensus could be reached. The valuation of financial receivables is an estimation process and should vary depending on the risks unique to the issuer.

2) Research and review data collected by the bank relative to underlying loans both at the time of the underwriting and on an on-going basis.

Superior provided E&Y with extensive bank information generated on an on-going basis as well as derived from bank records. A copy of Superior's valuation model was requested and received to test the data provided for four financial receivables (1999-1 fixed, 1999-1 ARM, 1999-3 fixed, and 1993-3 ARM). The model was reviewed for consistency of the functionality with the specific requirements of the related securitization documents. Further, it was reviewed for compliance with industry standards and GAAP. In addition, E&Y reviewed the structural features of the transaction for several other issues. First, the SEC requires the use of the "cash-out" method for valuing the pledged collateral requirement of each pool. Modeling specialists from E&Y's Structured Finance Services Group performed the testing.

E&Y concluded that the pledged certificates had a distinctively different character than cash flows of residual interest, the repayment of which comes solely from excess interest spreads. E&Y wrote that the pledged certificates were substantially secure as to principle and realized a current floating rate interest payment at a market rate. Further, the cash flow methodology of the model used by the bank was consistent

with this finding and was appropriate. E&Y concluded, that “the Bank’s methods are consistent with the “cash-out” method.

3) Evaluate changes in key assumptions and the inter-relationship to other key assumptions.

E&Y wrote that the most pronounced behavior influences for loan prepayments related to (1) fixed rate pools versus adjustable rate pools and (2) the variance between the contractual interest rate of the underlying loan and the interest rate currently available to the borrower which directly affected the borrower’s decision to exercise the option to prepay the loan and refinance the mortgage. While the above two factors appear to be the most influential, it must be noted that the second, market interest rate levels, is out of the control of the bank, while the first can be controlled.

According to E&Y, the bank’s methodology was developed to establish prepayment speed curves and expected future credit loss rates consistent with the characteristics of the mortgage loans within each pool or sub-pool both initially and as the pools age. Appropriately, the characteristics are evaluated based on the characteristics of the loans remaining in the pool at the time of valuation in order to recognize that the characteristics of the pool change through time. E&Y concluded that the methodology utilized by the bank was responsive to changes that occur in the make-up of the loan pool throughout the life of the pool.

4) Evaluate the Bank’s current practice of periodic evaluation of the appropriateness of key assumptions and the rationale for changes, which are adopted.

To accomplish this review step, E&Y reiterated what was contained in the September 28, 2000 Financial Receivables opinion memorandum regarding the discount rate, prepayment speeds, and credit losses. The conclusions for each of these factors mirrored what was contained in the September 28, 2000 Financial Receivables opinion memorandum.

For the discount rate, E&Y concluded that Superior’s methodology resulted in a reasonable discount rate and was responsive to changes in the characteristics of the underlying loan pool and applicable environmental factors, if applied in accordance with the methodology.

For the prepayment speeds, E&Y again concurred with the change in Superior’s estimation process for establishing a forecasted prepayment speed for the loans in the underlying loans in the pools. Based on the testing conducted, E&Y was of the opinion that bank personnel were establishing forecasted prepayment speeds based upon objective evaluation of the pool characteristics as of June 30, 2000 and that such assumptions were appropriately based and reasonable.

For the credit losses, E&Y reiterated what was contained in the September 28, 2000, audit opinion letter. E&Y added that as Superior's pools matured, credit loss and other assumptions would be revised to reflect actual results and changes in the characteristics of the loans in the respective pools.

5) Evaluate the effects of a potential change in the bank's method of accounting, both at the time of sale, and subsequently, relative to the recordation of the residual, the amortization thereof, income recognition and periodic impairment monitoring.

E&Y noted that Superior chose to record its investment in financial receivables as available for sale. As such, the asset was carried at fair value and any changes in unrealized gains or losses that Superior deemed to be temporary were recognized as a component of equity, net of its tax effect. Impairment, if any, that Superior deemed to be other than temporary was included in current earnings.

E&Y reviewed Superior's accounting policy and related calculations as of June 30, 2000. It was E&Y's opinion that the methodology conformed to GAAP as specified in FAS 125. Further, based on the results of E&Y's testing described in this report, E&Y noted no exceptions to Superior's application of the policy. E&Y noted that quarterly valuation calculations would be made beginning on September 30, 2000. The on-going quarterly revaluation of financial receivable assets would be subject to quarterly testing by both internal and independent third parties.

6) Review disclosures currently appearing in financial statements and other documents made available to investment bankers.

E&Y stated that the annual financial statements of Superior had consistently and historically complied with disclosure requirements related to financial receivables in accordance with GAAP. E&Y noted that nothing in the methodology changed or affected the disclosures as previously reported, with two exceptions. First, Superior had previously included in footnotes to the financial statements an item described as "cash flow escrow" variance. With the revised methodology adopted, such variances would no longer be measured as all financial receivables were adjusted to fair value on an individual REMIC³⁶ level. E&Y reasoned that the cash flow variance no longer had significance to the carrying value and had been removed from the footnote disclosure.

Second, the pledged certificates were reclassified to be included as mortgage-backed assets, which more closely reflected their underlying collateral and characteristics. E&Y agreed with the two changes and was of the opinion that the disclosures as of June 30, 2000 were in conformity with GAAP requirements and had been reflected consistently for all periods presented.

³⁶ A REMIC is a real estate mortgage investment conduit, which is a multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans. Refer to the glossary for the definition.

7) Compare and evaluate revised disclosures resulting from proposed changes in methodology, as well as revised disclosures required by recent proposed amendments to FAS 125.

E&Y wrote that the proposed amendment to FAS 125, to include enhanced disclosures, would be included in FAS 140 that would replace FAS 125, and would be effective for securitizations occurring after March 31, 2001. As such, the revised disclosure requirements were not yet effective and would not apply to Superior until the issuance of its June 30, 2001 audited financial statements. E&Y noted that while those disclosures were not yet required, compliance with the revised standards would require an expansion of current disclosures. The expanded disclosures would include key assumptions used in the valuation process, particularly related to prepayment assumptions and credit loss assumptions, as well as disclosure of sensitivity to changes in assumptions.

8) Suggest and perform additional audit procedures to test the effectiveness of any changes in valuation methodology adopted by the Bank.

E&Y noted that testing of the effectiveness of Superior's revised methodology was reported upon throughout its report.

As of October 10, 2000, E&Y was still on record in support of Superior's valuation and impairment measurement methodology for financial receivables.

October 2000 Field Visitation

On October 16, 2000, the OTS and the FDIC examination teams reconvened to conduct a field visitation to review Superior's progress in developing a Safety and Soundness Compliance Plan as directed by OTS following the January 2000 exam. The OTS and the FDIC team members reviewed E&Y's June 30, 2000 workpapers including the documentation associated with E&Y's May 2000 special engagement that evaluated the methodology, systems, and controls related to the valuation of the residual interest assets and compliance with applicable accounting standards. Superior's application of FAS 125 in performing the residual interests fair value calculations and its treatment of the OC account were endorsed by its external auditor E&Y, and became one of the visitation's largest concerns.

Again, examiners found E&Y's financial statement audit workpapers and documentation were less than expected in several areas, the most critical involving the OC account and the May 9, 2000, engagement project. Both the OTS and the FDIC were uncomfortable with the calculation of the OC account. The external audit workpaper review and numerous conversations with E&Y representatives and Superior's senior officers did not allay the examiners' concerns. The OTS and the FDIC examiners challenged Superior management and E&Y, advocating that the FAS 125 Q&A Special Report indicated that

when estimating the fair value of a credit enhancement³⁷ asset, assumptions should include the period of time that the use of the asset is restricted. FAS 125, paragraphs 42 through 44, provided guidance on how to estimate fair value. However, in December 1998 and July 1999, the FASB issued Special Reports in which a question (specifically Question #75) clarified the appropriate method to estimate the fair value of credit enhancements. Under the “cash-out” method, cash flows were to be discounted from the date the credit enhancement asset became available from the securitization trust on an unrestricted basis. In contrast, the “cash-in” method assumes the discount period ends when the cash is expected to come into the securitization trust although credit uncertainties may still remain. The Special Reports stated that a valuation method that does not discount credit enhancement assets for the entire period they are restricted is not an appropriate method to estimate fair value. In Superior’s structure, both the financial receivables and OC assets served as credit enhancement assets, therefore, the “cash-out” method for determining fair value appeared appropriate. The regulators contended that in order for Superior to comply with GAAP, the OC account should be carried at fair market value based on the “cash out” methodology outlined in the FAS 125 Special Reports issued in December 1998 and July 1999.

Throughout the October 2000 field visitation, meetings and conference calls among representatives from Superior’s management, OTS, FDIC, Superior’s holding company, outside consultants, and E&Y were held to attempt to arrive at a solution to the dispute over the accounting treatment afforded to Superior’s OC account. The dispute centered on E&Y’s contention that present value accounting is not required on the OC assets. E&Y’s contention was detailed in its September 28, 2000, Financial Receivables memorandum and E&Y’s Partner verbally communicated to examiners that the OC asset did not need to be discounted given that it is earning a market rate of return equivalent to the Class A bond rate.

On November 22, 2000, in a conference call with E&Y’s Partner, the Partner once again contended that E&Y’s audit work confirmed that although Fintek’s cash flow modeling was not similar to the E&Y technical expert’s “cash-out” structure, “the end results in terms of gross cash flows and present value are reasonably equivalent. Therefore, Superior’s financial receivables are stated at fair value and thus consistent with GAAP.”

E&Y’s Partner provided summary pages to the OTS and the FDIC participants for the first 61 months of the cash flow waterfall³⁸ that E&Y utilized for REMIC pool 1999-3 Fixed, which was based on the cash-out method, comparing it to the cash flow waterfall that E&Y estimated the Fintek (Superior’s) model would use. The Fintek cash flow was based on the cash-in method. To support his contention, the E&Y Partner presented the following summary information in a table that showed the results of E&Y’s modeling of Superior’s Series 1999-3 Fixed.

³⁷ Overcollateralization is a type of credit enhancement in which the principal amount of collateral used to secure a given transaction exceeds the principal of the securities issued. Credit enhancement occurs when a security’s credit quality is raised above that of the sponsor’s unsecured debt or that of the underlying asset pool. A type of internal credit support, such as overcollateralization assets, is employed to increase the likelihood that investors will receive the cash flows to which they are entitled.

³⁸ Waterfall refers to the sequential-pay cash flow allocation payments.

Table 3: Comparison of Superior’s Series 1999-3 (Fixed) Financial Receivable and Overcollateralization Actual Carrying Values to Fintek and E&Y Model Valuations

Model	Date	Discount (in 000’s)	FR-Net (in 000’s)	OC-Net (in 000’s)	Total (in 000’s)
E&Y “Cash-Out”	9/99	(\$24,275)	\$33,191	\$12,744	\$45,935
Fintek “Cash-In”	9/99	(\$24,245)	\$45,735	\$12,163 ¹	\$57,898
Superior Carrying Value	6/00	(\$20,999)	\$39,047	\$21,505	\$60,552

Source: OTS and FDIC Reports of Examination.

¹ Initial OC deposit booked by Superior at time of sale.

As illustrated, Series 1999-3 Fixed had an estimated value of \$45.9 million at the time of sale under E&Y’s “cash-out” method. However, as of June 30, 2000, Superior reported a combined financial receivable and OC carrying value of \$60.6 million. E&Y’s Partner was asked to explain this nearly \$15 million increase in the carrying value of Series 1999-3 Fixed over the relatively short 9-month time period. The Partner responded that, all other factors constant, the financial receivable carrying value would increase over time by the discount accretion.³⁹ The OTS and the FDIC examiners responded that the monthly accretion likely represented no more than \$4 or \$5 million (as evidenced by the above table). E&Y’s Partner had no other reasons for the remaining \$10 million carrying value Superior had recorded on its books. It was then evident that E&Y had not reconciled the results of its modeling tests to the actual carrying value on Superior’s books. Consequently, the information provided by E&Y’s Partner on November 22, 2000 failed to support Superior’s fair value modeling and accounting conventions for the financial receivables and OC carrying values.

On November 28, 2000, the OTS Regional Accountant wrote Superior’s Chairman of the Board advising him that the telephonic conference call with E&Y’s Partner on November 22, 2000, failed to resolve the regulatory concern about the OC asset. The Regional Accountant requested the following information pertaining to Superior REMIC pools 1999-1 Fixed and 1999-3 Fixed as of June 30, 2000 and September 30, 2000:

- The full cash flow waterfalls that were used in the Fintek and E&Y models to derive the value of the financial receivables and OC assets.
- A reconciliation between the E&Y cash-out method model results and Superior’s combined net book value of the financial receivables and OC assets for each pool.

On December 19, 2000, the OTS and the FDIC met with Superior executive management, E&Y representatives, and a consultant hired by the holding company, CCFC, to discuss the FAS 125 issue (Special Report Q&A #75 – Second Edition, December 1998 and Special Report Q&A #75 –Third Edition, July 1999.) E&Y’s Partner continued to support the accounting position taken in Superior’s fiscal year end 2000 audit that the OC assets did not need to be discounted. He contended that Superior

³⁹ i.e., the securities growth in value over time.

was complying with Q&A #75 since these assets were distinct and segregated property of Superior owned by Superior and pledged to the trustee/FGIC. The OTS and the FDIC representatives strongly disagreed, maintaining that the OC was a credit enhancement asset that should have been discounted in accordance with FAS 125 Q&A #75. The FAS 125 discounting issue remained unresolved at the end of the meeting. OTS agreed to give E&Y's Partner the opportunity to consult with other E&Y personnel and provide the regulators additional support for his position by January 3, 2001.

E&Y Agrees With Regulators

On January 11, 2001, a meeting was held among representatives from Superior's management, OTS, FDIC, Superior's holding company, outside consultants, and E&Y about the discounting issue. A national review official for E&Y acknowledged that E&Y's Engagement Partner was incorrect and the examiners' conclusions were accurate with respect to the appropriate accounting treatment applicable to the financial receivable assets. E&Y ultimately agreed that the regulators' position on the "cash out" method was valid. E&Y's review official from New York acknowledged that intensive study and discussions among E&Y, Superior, and the parent company shareholders had occurred since the December 19, 2000 meeting called by OTS. E&Y's revised position was reported to Superior and the shareholders on January 8, 2001. E&Y believed that recalculations for the initial recordation of the OC account were necessary along with reconstruction of the cash flow models for each securitization since inception. In short, the OC account should have been discounted and the cash flows from the trusts treated under the "cash out" method in accordance with FAS 125. Superior agreed to the need to perform recalculations. Superior's representatives requested additional time to recalculate the accounting value of residual interests on its books and estimated that this work could take as long as 90 days. This revaluation resulted in a mandatory write-down of the overcollateralization account totaling \$270 million that was recorded during the first quarter of 2001.

The audit of Superior's June 30, 2001 financial statements was not completed before Superior closed. In addition E&Y was subsequently replaced by Arthur Andersen, LLP, as Superior's external auditor.

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

Disregard for the Regulatory Process

Superior management failed to implement several examination recommendations subsequent to the January 1999 examination and continued to delay required adjustments

to the financial statements during the course of an OTS field visit. Superior management's reluctance to conform resulted in Superior filing inaccurate TFRs. Management did not write-off 100 percent of an automobile loan category as directed by OTS, did not write-off future advertising credits as directed by OTS, and did not adjust the classification of certain loan assets that Superior reflected as being sold without recourse, but were sold with recourse. The effect of these adjustments on Superior's capital ratios was unfavorable because they would have required Superior to increase capital by \$24 million. Superior's TFR showed that it met the risk-based capital (see Topic 5 and Glossary) definition of a "well capitalized" institution by only \$1,543 million at June 30, 2000. OTS should have required Superior to file corrected TFRs when material errors were found, and taken enforcement actions against Superior and its management when Superior continued to delay required adjustments to the financial statements. The following table summarizes the adjustments that were not made with the effect of the adjustments at June 30, 2000.

Table 4: Summary of Overstated Capital Because Superior Did Not Make Adjustments Required by OTS

Description	Amount Pretax	Effect
Prepaid Advertising Adj.	\$ 3,002,000	Reduce Capital
Note Suits Adj.	8,983,292	Reduce Capital
Recourse Loan Sale Adj.	10,784,000	Additional Capital Requirement
Auto Bankruptcies Adj.*	1,247,000	Reduce Capital
Total Pretax Capital Needed	\$24,016,292	

Source: OIG analysis of OTS October 2000 Field Visitation Report

* The CFO did not include the \$1.2 million in bankruptcy adjustments for June 30, 2000 because he was unable to separate the accounts to show those that had perfect payment histories for the past 6 months.

The OTS Regulatory Handbook, Section 10, Handbook Use, and Section 70, Overall Conclusions, sums up the regulatory process as an assessment of an institution's degree of safety and soundness and an objective evaluation of its condition by OTS personnel who report their findings, inform the institution's Board of Directors of strengths and weaknesses, and facilitate corrective action where needed. The primary goal of the regulatory process is to ensure that institutions are operated in a safe and sound manner and that the regulatory process prevents problems from developing or escalating in the future; therefore, early identification of risk is necessary.

Also, Section 330 of the OTS Regulatory Handbook entitled, Management Assessment, further delineates management practices and procedures that OTS examiners need to assess in their evaluation of an institution's management. In addition to evaluating the knowledge, skills, and abilities of individual managers, the results of their decisions, and the institution's regulatory compliance and financial performance, examiners must consider the responsiveness to recommendations from auditors and supervisory authorities. Supervisory authorities look to management to implement corrective action in response to directors' requests and regulatory supervision requirements. Management should establish procedures to ensure continuing compliance. Corrective action must be

responsive to the cited criticism and implementation of appropriate action must be timely. Management must explain any noncompliance with supervisory requirements.

According to OTS regulation 12 CFR 560.160, *Asset Classification*, each savings association must evaluate and classify its assets on a regular basis in a manner consistent with, or reconcilable to, the asset classification system used by OTS in its *Thrift Activities Handbook*. In connection with the examination of a savings association or its affiliates, OTS examiners may identify problem assets and classify them, if appropriate. The association must recognize such examiner classifications in its subsequent reports to OTS. Based on the evaluation and classification of its assets, each savings association shall establish adequate valuation allowance or charge-offs, as appropriate, consistent with GAAP and the practices of the federal banking agencies.

Generally, Superior's management officials were responsible for planning, policy-making, personnel administration, maintenance of internal controls, and management of information systems. In addition, a specific Superior key manager, the Chief Financial Officer (CFO), was responsible for classified asset reporting and for providing OTS examiners with requested financial data, budgets, accounting information, and most major operational data requests. The CFO was considered the primary person responsible for verification of the major assets of Superior, including the preparation of Superior's financial statements and TFRs. The CFO also was a signatory on the annual Management Letter examined by E&Y during the annual audit. During OTS examinations prior to the 2000 exam, the CFO was cooperative and quite prompt about supplying requested information to examiners. However, during the 2000 examination and subsequent field visitation, OTS began to question the credibility of the CFO and other Superior management personnel. Specifically, the OTS questioned the handling of directed write-offs and the filing of erroneous TFRs.

Prepaid Advertising

During the course of the 2000 examination, a \$12 million difference was noted between the classifications of assets reported at December 31, 1999 and problem assets listed on Superior's Management and Servicing Report for the same date. The examiners' subsequent request for management's explanation of the difference resulted in identifying the sale of \$12 million in problem assets. The examiners requested and received a copy of the sales agreement dated December 22, 1999, between Superior and an advertising agency located in New York. The agreement revealed that Superior swapped \$5 million in repossessed autos and \$7 million in liquidated deficiencies for future credits or discounts on future advertising to be placed with the agency. Superior recorded the transaction by simply debiting Prepaid Advertising (\$12 million) and crediting loans (\$12 million.) To obtain the credits, Superior would be required to spend \$67.3 million within 4 years at prices determined by the advertising agency. Superior management informed OTS examiners that no previous advertising programs had been placed with the advertising agency.

The OTS Regional Accountant determined that the transaction had little or no value and Superior had actually received assets that were inferior to those that were traded. Consequently, the OTS informed Superior that the entire \$12 million in future trade credits must be written-off as of December 31, 1999. The value of the credits could not be determined, were contingent upon future Superior spending outlays, and were not marketable as cash equivalents. In addition, the credits were suspect as to the claim of providing extraordinary discounts that would not be similarly offered to other financial institutions proposing large advertising contracts.

Superior's management disagreed with the OTS evaluation of the transaction and stated that the agreement was legal and Superior intended to spend the \$67.3 million as part of its future business plans. Superior disagreed that the sales transaction had little or no value and stated that the future credits had substantial value. As of September 30, 2000, Superior only wrote off \$9.6 million of the \$12 million. The CFO tried to reason that it was appropriate because regulatory policies allowed a write down to collateral value, less selling costs. Because Superior did not make the adjustment required by OTS, Superior's risk-based capital was overstated by \$3 million.

Note Suits

Another example of management's disregard for the regulatory process was the handling of another OTS directed write-down of a loan category called "note suits" where Superior was attempting to repossess automobiles, but borrowers had hidden or transported the autos to unknown locations. During the January 24, 2000 examination, Superior was directed in writing and verbally to write-off 100 percent of the note suits category. Superior management agreed to write-off \$10.2 million (the original balance of the note suits at December 31, 1999, that OTS later reduced to \$8.98 million) in accordance with the Uniform Credit Classification and Account Management Policy, a policy adopted by the OTS and other banking agencies. The Uniform Retail Credit Classification and Account Management Policy establishes standards for the classification and treatment of retail credit in financial institutions. According to the policy, closed-end retail loans that become past due 120 days from the contractual due date should be classified a loss and charged-off. The decision to write-off the account was made after extensive discussions with OTS personnel on the Uniform Retail Credit Classification and Account Management Policy. Written instructions to Superior's management to write-off note suits were presented at the examination exit meeting, and the requirement was specifically addressed in the examination report, which was submitted to all directors.

Subsequent to the January 2000 examination exit meeting, a Superior management official responded on behalf of the Board of Directors, that all necessary adjustments were reflected as of March 31, 2000. However, during the OTS October 2000 field visit, OTS examiners discovered that the response was not correct. Superior management did not write-off 100 percent of the note suits as required. Without seeking feedback from the OTS, management renamed and subdivided note suits into two new categories—"Third Party Collections-Out for Repossession" under the substandard category and "Third Party Collections-Other" under the loss category. The CFO explained that management took

the position that if the servicing department determined that the repossession of an auto became more likely with a severely delinquent account, the account could be moved to the 90-day category, regardless of the actual delinquency status. This practice avoided placing these accounts into the 120-day category and thus classifying them as losses to be charged-off. OTS explained to the CFO why this practice was illogical. OTS reasoned that delinquency histories could not be changed based upon a servicing department's claim that the auto now has a better chance of being repossessed. No one from Superior's management informed the OTS of their actions at any time between the examination date and the date of the OTS October 2000 field visit, even though they had several months to do so. Their actions were discovered during the October 2000 field visit through the examiners' review of source documents on classified assets. The CFO said that he was not "playing games" when questioned as to why management changed the severe delinquency status without any actual change to the delinquency status by the borrower. He added that Superior management believed they were following the Interagency Guidelines in classifying assets.

The October 2000 field visitation scope included a review of Superior's external auditor's (E&Y's) workpapers for Superior's fiscal year ended June 30, 2000. During the course of the review, which was held early in the field visit, discussions were held with the Manager of E&Y's Superior audit in addition to E&Y's Partner. When both the Manager and Partner were questioned by OTS whether they had read the January 2000 OTS report of examination, they both responded that they did not see OTS's report of examination. OTS informed E&Y's Partner that OTS did not consider the audited financial statements as of June 30, 2000 to be accurate, because Superior did not record the adjustments to note suits or prepaid advertising (discussed above) as required by the previous examination. The Partner responded that E&Y must not have considered the issues to be material. When again questioned why auditors would not read a regulatory report on a subprime lending institution with an overall rating of "4," E&Y's Regional Partner replied that it just "slipped through the cracks." At a later date, he amended his reply and added that he remembered reading the OTS report in New York City in the presence of Superior's Chairman of the Board. He said that he was not allowed to make copies of the report. In response to OTS inquiries on why E&Y was not allowed to receive a copy of the OTS examination report, E&Y's Partner responded that this was not unusual and other clients also had similar policies. He went on to say that E&Y probably did not consider the issues material.

OTS's review of E&Y's workpapers for the fiscal year ended June 30, 2000 revealed the possibility that Superior had initially submitted a different classified asset schedule to the OTS examiners compared to schedules submitted to E&Y. E&Y's workpapers still showed the note suits category at June 30, 2000 and E&Y's workpapers defined the note suits category, discussed the note suits balances, and noted that approximately one-third of the note suits were written-off "per the OTS examination." OTS concluded that E&Y believed that the note suits still existed as E&Y showed a sizeable balance of \$12.4 million at June 30, 2000. E&Y's workpapers did not show the new categories of Third Party Collections-Other and Third Party Collections-Out for Repossession. The initial schedules given to the examiners for the same date did not show the note suits

category, but showed the newly renamed Third Party Collections-Other and Third Party Collections-Out for Repossession. Because Superior did not make the adjustment required by OTS, Superior's risk-based capital was overstated by \$8.9 million.

Recourse Loan Sale

The CFO did not adjust the classification of certain loan assets that Superior reflected as being sold without recourse but were actually sold with recourse. Superior sold \$207 million in auto loans into a trust as of May 31, 1999. Management stated that the likelihood of recourse to Superior through this sale was remote. However, examiners determined that in fact, Superior had retained recourse for losses from the trust and the bondholders had no exposure to losses. The OTS report of examination recommended to Superior's Board of Directors that the board should ensure that management had reflected all necessary adjustments and reporting requirements to earnings and capital as of March 31, 2000. The report of examination also recommended that the board ensure that management classified all balance sheet assets and off-balance sheet recourse obligations in accordance with the Uniform Retail Credit Classification Policy. (Refer to Topic 5 for a detailed discussion of this policy and its impact on Superior.)

The January 2000 examination report clearly detailed the OTS's conclusion as to whether recourse existed from a \$207 million auto loan sale that occurred during 1999.

Management had previously determined that recourse did not exist and informed the OTS of this conclusion in at least one meeting held prior to the January 24, 2000 examination date. However, the examiners later determined after a review of the legal documents that, contrary to management's claim, the sale did include a recourse provision whereby Superior accepted recourse for losses through the structure of the transaction. The probability of losses being incurred by Superior was remote, but the examiners and the Regional Accountant determined that recourse did exist. Consequently, Superior's management was verbally informed during the January 2000 examination of this conclusion. A written memo was given to management during the examination that explained the rationale for the OTS decision. The memo was again presented at the exit meeting near the end of the examination. The subject was also clearly explained in the examination report. In all instances, Superior was instructed to convert the underlying loans to on-balance sheet assets at the 100 percent risk-weighted category in the risk-weighted asset calculation on the TFR. The Board of Directors' reply to the examination report stated, "Management has taken steps to reflect all necessary adjustments and reporting as of March 31, 2000 in accordance with the comments included in the Report of Examination."

The OTS October 2000 field visit disclosed that management did not implement the instructions as required. Instead, management significantly reduced the capital effect of OTS's instructions by reporting a "low level recourse" situation, even though the low level recourse was not applicable. Management never informed the OTS that it had made this decision and at no time during the previous examination did management ever discuss low level recourse as an option. Similar to note suits and the prepaid advertising examples, the examiners found management's unilateral decision through a review of the capital calculations in the TFR. Management considered the low level recourse

calculation as appropriate and did not have a response to OTS's question of why Superior never informed the OTS that it was considering other interpretations of OTS's original detailed instructions. Because Superior did not make the adjustment required by OTS, Superior needed to increase risk-based capital by \$10.8 million.

Thrift Financial Report Errors

Management displayed disregard for the regulatory process by filing erroneous TFRs from 1998 through 2000. TFRs in 1998, 1999, and 2000 contained material errors that overstated Superior's capital position. In its 1997 examination report, OTS found delinquent auto loans and repossessions had not been included in classification totals in regulatory reports (TFRs) during 1997. The classification totals were shown on Schedule VA—Consolidated Valuation Allowances and Related Data, of the TFR. Specifically lines VA960, VA965, VA970, and VA975 showed End of Quarter Balances for Special Mention,⁴⁰ Substandard,⁴¹ Doubtful,⁴² and Loss⁴³ classifications, respectively. As reported, classified assets were below the levels reported by other institutions like Superior—its peers—as of September 30, 1997.

Superior did not include all appropriate classified assets, including delinquent auto loans and repossessions and real estate owned, in TFR reports to OTS during 1997. If these assets had been included as of September 30, 1997, it would have resulted in a doubling of classified assets and a revision of Superior's classified asset status from below peer level to above peer level. Notwithstanding, OTS examiners concluded in 1997 that the higher classification levels were still not a concern due to the extremely high earnings and acceptable capital level of Superior. There were no matters reported that required a response from the Board of Directors. Management provided assurance that the classified asset totals in future regulatory reports would include all appropriate assets.

According to the OTS Regulatory Handbook, Section 410, Financial Records and Reports, the accuracy of the TFRs is extremely important, because information contained in the reports is used to monitor savings associations between examinations. If inaccurate

⁴⁰ On June 10, 1993, the federal banking and thrift regulatory agencies issued uniform guidance to clarify the use of Special Mention for supervisory purposes. The four agencies adopted the following uniform definition for Special Mention assets: The Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

⁴¹ An asset classified Substandard is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any.

⁴² An asset classified Doubtful has the weaknesses of those classified Substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

⁴³ That portion of an asset classified Loss is considered uncollectible and of such little value that its continuance as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer writing off a basically worthless asset even though partial recovery may be effected in the future.

data are submitted, changing patterns of behavior or deteriorating trends may not be detected in an individual savings association. If compounded, a distorted picture of the industry condition can result. The OTS must have reliable data so it can assess and monitor a savings association's financial condition and activities. The regulator should ascertain whether any reports are presented to the Board of Directors in addition to the required reports such as the TFR. The content of any additional reports should also be reviewed for accuracy and adequacy. Regulators should also determine whether the submission of inaccurate or inadequate reports is the result of an intentional act on the part of management. The regulator should follow up on all items deemed worthy of further investigation and obtain a satisfactory response from management, explaining specific questionable matters.

Although OTS was not concerned after its 1997 examination, OTS changed its position during the 1999 examination when OTS examiners found that classified asset levels remained lower than reported to OTS for all quarterly periods in 1998. Notwithstanding management's assurances following the 1997 examination, classification errors were not detected within Superior's review process. The institution's classification policy required the CFO to prepare quarterly classified asset reports for review by Superior's Board of Directors. The CFO's quarterly classified asset report included delinquency and repossession reports from all four of Superior's divisions. However, OTS examiners found no individual report existed to summarize the final conclusion for Superior's classified assets except the TFR. Examiners concluded that the TFR data was insufficient for the Board of Directors to properly analyze the 19 categories of classified assets from Superior's four divisions that comprised classified asset totals at December 31, 1998. The CFO initially disagreed with the examiners' final classification totals, but subsequently agreed to include the revised asset categories in future reports. The CFO later agreed to prepare a summarized asset classification report for the Board of Directors on a quarterly basis.

OTS conducted a field visitation in September 1999 to review corrective action on the findings of deficiencies in management reporting of classified assets at the safety and soundness examination dated January 25, 1999 and the apparent continued reporting deficiencies in two TFRs. The OTS field visitation report indicated that management improved Superior's classification reporting system and internal reports because the reports now included all known balance sheet assets for classification consideration. However, Superior management's analysis of the problem assets was unacceptable and resulted in the continued understatement of classified assets on Superior's TFRs as of March 31 and June 30, 1999. The understatements were attributed to the auto loan division. Consequently, OTS gave detailed written instructions to management for each category of problem auto receivables.

Management erroneously designated a substantial portion of its impaired auto loan receivables as special mention and also incorrectly calculated expected loss amounts on certain auto receivable categories that resulted in a less severe classification for the remaining balance. This resulted in classifications being underreported by approximately 50 percent on the June 1999 TFR. The June 1999 TFR showed \$40.8 million in

classified assets; however, OTS examiners tallied amended totals of \$61.1 million in classified assets for criticized assets as of June 30, 1999. Management also underreported, on the TFR, the total allowances for the auto division for the first two quarters of 1999. The underreported amounts on the TFRs were \$19.5 million for March 1999 and \$26.8 million for June 1999. Again, management promised to follow the instructions and revise the TFRs as well as increase the classified asset categories for June 30, 1999.

During the January 2000 examination, the OTS and the FDIC examiners focused on Superior's valuations of residual interests and the classification of problem assets identified in the previous examinations. At previous examinations, Superior was found to be underreporting the level of classified assets on its TFRs, but the 2000 examination found that management had included all the loans on the institution's balance sheet for classification consideration. However, examiners determined that the previously reported ALLL was incorrect. The examination found that Superior incorrectly reported the ALLL on the December 31, 1999 TFR. Superior reported \$128.5 million in the ALLL; however, the examiners concluded that only \$2.6 million was eligible for inclusion in the ALLL as of December 31, 1999. The previously reported ALLLs were largely determined by examiners to be incorrect and the excess market value over book value of the financial receivables was erroneously designated as part of the ALLL. Table 5 summarizes the reasons for the significant restatement and shows the actual verified ALLL.

Table 5: Summary of the ALLL

Description	Balance (000's Omitted)
Reported ALLL at December 31, 1999	\$128,519
Less TFR Reporting Error	(2,922)
Less Reclassification of Allowances	(76,884)
Subtotal	\$ 48,713
Less "Unverifiable Cushion"	(46,115)
Actual Verified ALLL	\$ 2,598

Source: OTS January 2000 Report of Examination.

The OTS January 2000 report of examination attributed \$2.9 million to TFR reporting errors but did not explain how OTS identified the errors. As for the \$76.8 million, the report of examination explained that the initial adjustment to the ALLL was required by a new understanding of the financial receivables book balances compared to management's valuation of the receivables. Superior's general ledger as of December 31, 1999 showed a gross book balance of \$663.4 million for financial receivables. However, management submitted a valuation of the financial receivables during the examination totaling \$586.6 million for the same date. The initial difference of \$76.8 million between the gross book balance and management's valuation represented a loss or write-down that removed this respective amount from the ALLL category. The remaining \$46.1 million "cushion" that management categorized as an ALLL was technically an unrealized gain

and not an allowance. During the examination, management was requested to find support for this amount but was unable to support the claimed “cushion” or unrealized gain of \$46.1 million. Table 6 shows the amounts of the verified ALLL categorized by Superior’s operating divisions.

Table 6: Summary of Verified ALLL by Superior Operating Division

Adjusted ALLL	Balance (000’s omitted)
Superior Direct	\$ 3
Universal	9
Alliance Funding	345
Retail	827
Auto Division	1,414
Total Revised ALLL	\$2,598

Source: OTS January 2000 Report of Examination.

In addition, the OTS and the FDIC examiners found numerous errors on Superior’s September and December 1999 TFRs that also distorted Superior’s financial condition. A prime example cited in the January 2000 OTS examination report was financial receivables totaling \$672.4 million that were overstated on the TFR Schedule SC-Consolidated Statement of Condition —Mortgage Derivative Securities, SC line 150, \$666.6 million and Other Investment Securities, SC line 185, \$5.6 million. According to the Thrift Financial Report Instruction Manual, these assets should have been reported as IO Strip Receivables and Certain Other Instruments on SC line 655. According to the TFR instructions for SC line 655, Superior should have reported the amortized cost of the portion of interest-only strip receivables, loan receivables, other receivables, or residual interests in securitizations. These assets had to be amortized because they could be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

After the January 2000 examination, Superior’s board was given a list of items for management to address. Among them were necessary adjustments and reporting requirements to earnings and capital as of March 31, 2000. Also, the board was to ensure that management took actions to support the valuations of the residual interests, to determine a sufficient ALLL, and other actions. One of the other action items involved measures that were needed to prevent information delays caused by the CFO during the 2000 examination. Requests for documentation that were forwarded to Superior prior to the commencement of the examination and follow up requests were not answered in a timely manner. The CFO was primarily responsible for providing the requested information.

In October 2000, the OTS and the FDIC teams reconvened to conduct a field visitation to review Superior’s progress in developing a Safety and Soundness Compliance Plan (a Corrective Plan delineated in 12 CFR Part 570) and other issues identified during the previous examination. In general, they found that Superior’s management continued to operate outside of a disciplined framework expected of an insured depository institution.

The OTS field visitation report concluded that Superior's financial statements were not fairly stated as of June 30, 2000. The reported financial statements had apparent misstatements on asset valuations, which would result in a corresponding significant adverse impact on Superior's capital position. The OTS and the FDIC examiners concluded that the residual interests and the OC account were substantially overstated as of June 30, 2000, and also as of September 30, 2000. The examiners estimated that the inflation of the financial receivables and OC assets ranged from a minimum of \$200 million to as much as \$300 million as of June 30, 2000. Subsequent to the October visitation, meetings among the OTS, the FDIC, E&Y, and holding company personnel were held to come to some type of an agreement on the issue. At a meeting held on January 11, 2001, a national review official from E&Y acknowledged that Superior's and E&Y's position on the accounting treatment for the OC account was incorrect. The OTS and the FDIC's position were the correct interpretation of Statement of Financial Accounting Standard (FAS) 125. In March 2001, the OTS and the FDIC conducted what would be their last examination of Superior.

In addition to Superior's incorrect interpretation of FAS 125, Superior's financial statements and TFRs at June 30, September 30, and December 31, 2000 also contained other significant errors. The CFO filed all of these TFRs and was ultimately responsible for the accurate and timely filing of TFRs. Superior's Board of Directors removed the CFO in early January 2001.

OTS advised Superior by letter, dated May 3, 2001, of substantial questions about the accuracy of Superior's March 31, 2001 TFR. Several representations by management concerning the calculation of the financial receivables and OC assets, during a critical phase of OTS's 2000 examination, were later determined to be incorrect. According to an OTS memorandum, OTS believed the CFO, who was removed in early January 2001, made false and misleading statements to examiners, in violation of 12 CFR §563.180(b)(1). The October 2000 field visit was considerably lengthened by management's failure to provide requested documentation in a timely manner, and by the submission of incomplete documents. OTS should have required Superior to file corrected TFRs when material errors were found and taken enforcement actions against Superior and its management when Superior continued to file erroneous TFRs.

Topic 4 - Regulatory oversight of the institution's high-risk lending activities including the underwriting and accounting practices used by the bank for origination and securitization of subprime⁴⁴ loans.

With the exception of 1998, the Office of Thrift Supervision (OTS) conducted annual safety and soundness examinations of Superior from 1991 until its closure. OTS' emphasis centered on the securitization process, which was the mainstay of the institution. The OTS also conducted reviews of the underwriting of the loans, which served as the collateral for the securitizations. Additionally, beginning with the 1996 examination, the OTS used capital markets specialists to conduct extensive reviews of the securitization process. The Federal Deposit Insurance Corporation (FDIC) participated in the 2000 examination and visitation and the 2001 examination. The FDIC also included capital market specialists on its staff. The accounting practices that Superior used were reviewed. At the January 2000 examination, both agencies questioned the assumptions that Superior used to value the residual interests. During the October 2000 visitation, it was determined that the accounting practices were not interpreted correctly and the OC account and the residual interests were overstated. Subsequent write-downs at the March 2001 examination further reduced Superior's capital.

The Review of Residual Interests

The Office of Thrift Supervision (OTS) maintained an annual examination presence in Superior from 1991 until its closure.⁴⁵ Superior's management commenced its securitization business in March 1993 following the incorporation of Alliance Funding Company, Inc. (Alliance) as a division of Superior in December 1992. As part of the examination process, the OTS reviewed the activities related to the securitization process. The OTS's major concern was the increasing volume of residual assets⁴⁶ on Superior's financial records. The 1994 examination included a recommendation that the board

⁴⁴ The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

⁴⁵ An examination of Superior was not conducted in 1998.

⁴⁶ The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

establish limitations on the volume of residual assets as a percentage of capital that the institution would permit. The Board of Directors did not implement the recommendations and continued to expand Superior's holdings of residual assets. Beginning in 1995, the OTS still had concerns; however, the OTS reports stated that Superior's capital levels mitigated their concerns regarding the high level of concentrations. The residual assets were listed as a concentration; however, the OTS did not take any further action regarding this mounting level of high-risk assets until the OTS issued the Part 570 Directive in July 2000.

The OTS examinations from 1993 through 1995 identified shortcomings in Superior's financial reporting. The residual assets were incorrectly categorized on the Thrift Financial Reports (TFR). The first reported instance of incorrect reporting occurred in 1993. A reminder was given to the board and management on where to correctly include the totals on the TFR. The same errors occurred on the 1994 TFR. The OTS continued to remind the board throughout this period about the need to accurately report values on the TFRs; however, no corrective action was taken. The 1996 examination report did not indicate whether or not the reporting errors were corrected. Superior continued to file inaccurate TFRs, as reported in the 1997, 1999, 2000, and 2001 examination reports.

Superior began extending and securitizing subprime automobile loans in 1994. In addition to the other focal points, the OTS reviewed the automobile lending area and its securitization activities. One of the criticisms in the examination reports from 1997 until 1999 pertaining to this area included the omission of delinquent auto loans and repossessions from the balances of classified assets reported in the TFRs.

In 1996, the OTS conducted an intensified examination of the securitization process at Superior. OTS Washington elicited the assistance of an examiner from the OTS's Southeast Region to provide expertise in the securitization area on this examination. After reviewing the documentation, he determined that the valuations were reasonable and no criticisms were levied in this area. Similar results were obtained from the 1997 and 1999 examinations.

Because of Superior's size, the Federal Deposit Insurance Corporation's (FDIC) off-site monitoring was required through the former Billion Dollar Insured Depository Institution⁴⁷ program. In October 1998, an FDIC case manager was reviewing Superior's TFR and E&Y's audit report that were submitted as required by 12 CFR Part 363. He noted the inordinate size of the residual assets and the ALLL in relation to other financial institutions. The case manager contacted the OTS field manager to inquire about participating in the upcoming OTS examination in order to alleviate the FDIC's concerns. According to protocol, the FDIC prepared a letter to the OTS requesting permission to join the examination. The OTS regional director stated that he never saw the letter. The FDIC did not gain access to the institution; however, FDIC personnel were allowed to present questions to the OTS examiners which were discussed between the two agency representatives during the last week of the examination. (Refer to Topic 9 for a detailed discussion of the FDIC's efforts to participate in the 1999 OTS examination.) After

⁴⁷ Refer to the Glossary for an explanation of the Billion Dollar Insured Depository Institution program.

reviewing the OTS's Report of Examination, the FDIC downgraded the rating from the composite "2" assigned by the OTS to a composite "3" for risk related insurance premium purposes.

The 2000 Examination

Three FDIC examiners joined the OTS at the 2000 examination of Superior. At the conclusion of the examination, the institution was rated a composite "4" by both regulators. Following the January 25, 1999 examination, Superior's management changed its assumptions for valuing the residual interests, thereby inflating their values. The level of residual assets was growing at an excessive rate. The total of adversely classified assets had increased, primarily from the automobile division, and write-downs were required to reflect accurate values for the assets. The Allowance for Loan and Lease Losses (ALLL) was overstated due to the inclusion of valuation reserves for the residual interests that should not have been included in the ALLL. Following examination adjustments, the total in the ALLL declined from \$128 million to \$2.6 million.

The OTS calculated the capital ratios at the conclusion of the examination to determine Superior's Prompt Corrective Action (PCA) category. Loss classifications were calculated on a pre- and post-tax basis prior to calculating the capital ratios. Because OTS used the post-tax capital calculation of 8.57 percent versus the pre-tax value of 7.81 percent, Superior was considered adequately capitalized instead of undercapitalized for PCA purposes. During interviews with OTS examiners and executive personnel, we asked if this practice of calculating examination losses on a pre-and post-tax basis was customary. According to the OTS Regional Director in Chicago, this practice is used at the discretion of examiners to reflect a more accurate picture of the institution's capital position. An effective⁴⁸ tax rate of 39 percent was used to perform the calculation. In contrast, the OTS's Chief Accountant stated that an effective tax rate could not be used on an institution that has a complicated income tax structure and return. By calculating the ratios on a post-tax basis, OTS classified Superior as an adequately capitalized institution following the January 24, 2000 examination instead of an undercapitalized one. This practice was also used by OTS to determine Superior's PCA category as of December 31, 2000. Because of the effects of post-tax losses and the exclusion of the \$150 million write-down associated with the residual interests⁴⁹, Superior was classified for PCA purposes as significantly undercapitalized during the March 2001 examination. If these adjustments were made, it is probable that Superior would have been critically undercapitalized. Refer to Table 8 for a detailed listing of specific capital ratios.

An area of uncertainty arose during the January 2000 examination. The examiners questioned the unsupported assumptions used to value the residual interests. The

⁴⁸ The effective tax rate is the amount of tax divided by the taxable income.

⁴⁹ The write-down of the residual interests was deferred because of negotiations between the OTS and Superior's owners to devise a recapitalization plan. We do not understand why this would justify any delay in writing down the assets, but it had the effect of inaccurately presenting the institution's financial condition. The write-down was incorporated in July 2001 when the owners failed to implement the recapitalization plan.

examination review indicated an initial impairment of \$1.2 million on certain mortgage pools. The OTS recommended that Superior implement procedures to determine the fair value of the residual interests and adjust the book values accordingly. Both regulators downgraded Superior to a composite rating of “4” following the 2000 examination. In July 2000, the FDIC again downgraded Superior for risk related insurance premium purposes because of the results of the 2000 examination. In July 2000, the OTS issued a Part 570 Directive to address the deficiencies noted at the January 2000 examination.

The October 2000 Visitation

During the October 2000 visitation, the agencies determined that Superior and E&Y were not applying Statement of Financial Accounting Standards (FAS) 125 correctly to the valuation of the OC account. It appeared that the incorrect valuation process had been in place since the inception of the account in 1995. Discussions with the accountants and Superior personnel ensued and in January 2001, the issue was resolved. The national partner from New York reviewed E&Y’s work and determined that the regulatory agencies were correct in their interpretation of FAS 125.

The 2001 Examination

The FDIC participated with the OTS in the March 2001 examination. Write-downs associated with the OC account to bring the valuation into conformance with FAS 125 negatively affected Superior’s capital position. Superior was now considered significantly undercapitalized for PCA purposes. Additionally, because Superior was unable to produce adequate documentation to support its valuation assumptions, further write-downs were expected for the residual interests. According to the 2001 draft FDIC examination report, if all examination losses were deducted from capital, Superior would have been insolvent. The OTS issued a PCA Directive to Superior on February 14, 2001, which placed restrictions on the distribution of capital, asset growth, compensation paid, and restrictions on acquisitions, branching, and new lines of business. Superior was also required to file a capital plan. Specific requirements pertaining to the establishment of an escrow account and the sale of loans were also included in the directive. The OTS issued Cease and Desist Orders to Superior’s first and second tier holding companies, Superior Holdings, Inc. and Coast-to-Coast Financial Corporation on February 14, 2001. The Order required the holding companies to establish an account at Superior with a specified dollar amount to absorb any losses Superior incurred on loan sales. Neither holding company was permitted to declare or approve any capital distributions; renew or incur any debt without the written approval of the Regional Director; pledge or encumber any assets of the holding companies or Superior; or maintain, renew, or modify existing warehouse lines of credit to finance the purchase loans from Superior. Also, the holding companies were directed to follow Generally Accepted Accounting Principles.

The OTS and Superior’s owners began negotiating a recapitalization plan as required under PCA. Superior submitted a Capital Plan on time; however, the OTS did not consider it acceptable. Three amendments and two revisions later, the OTS accepted the Capital Plan. The owners were required to implement the plan no later than

July 23, 2001. However, after lengthy negotiations, the owners decided not to implement the plan. The OTS declared Superior insolvent and closed the institution on July 27, 2001.

Underwriting

Prior to becoming an affiliate and later a division of Superior, Alliance's main line of business was originating, purchasing, and securitizing non-conforming mortgage loans. Alliance used a network of 968 brokers located throughout the United States from whom they purchased loans. According to OTS personnel and examination reports, the level of loans that were obtained from these indirect sources ranged from approximately 70 to 80 percent of the loans that were securitized, with only 20-30 percent generated from within the organization. Since brokers typically generate their compensation based on the volume of loans that are accepted by the institution, they are more inclined to use aggressive techniques to solicit borrowers. Also, in a declining interest rate environment, brokers may attempt to entice the more creditworthy borrowers to refinance their loans, which can increase the prepayment risk to institutions that have packaged these loans in securitizations.

In 1999, Superior originated 31,744 one-to-four family mortgage loans totaling \$2.2 billion. These loans were categorized into three income verification categories including full income verification, partial income verification, and non-income verification. These three categories were further divided into 13 categories based on the underwriting standards that ranged from "A" type borrowers to "C" type borrowers. This group also included a few "D" type borrowers. Generally those borrowers that fell into the lower credit quality group must have more equity in their residences compared to the higher credit quality borrowers. Superior obtained credit scores; however, they were seldom used since each loan was underwritten on an individual basis. According to the OTS and FDIC examiners and DRR personnel that reviewed the loans supporting the securitizations, the loans extended in the earlier issues were better quality. In contrast, the loans in the later issue had high delinquency rates and large losses indicating the liberalization of lending standards in order to generate a higher volume of loans.

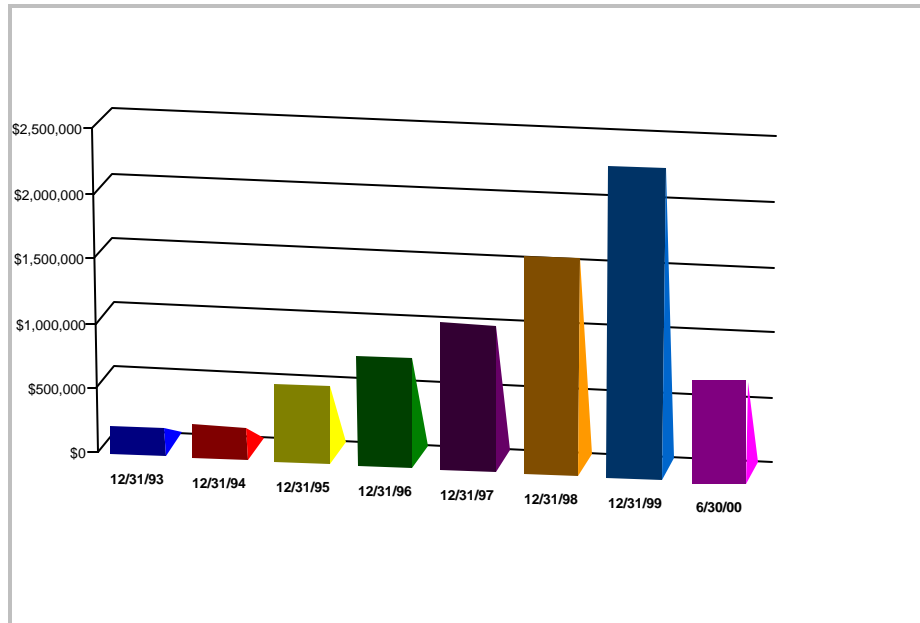
Other influences noted by OTS personnel, which may have contributed to Superior's lowering the credit quality standards, included the following:

- Competition in the subprime market was increasing and becoming more aggressive,
- Superior wanted to increase the volume of securitizations (that is, by lowering the credit standards, there was a larger population of subprime candidates to include), and
- Superior directed its advertising campaigns to lower quality borrowers who may have elected to take advantage of the loans.

Loan to value ratios on the mortgage loans were reported to be in the high 70 to the low 80 percent range. However, OTS personnel indicated that second mortgages were

included in some of the securitizations and therefore the loan to value ratios could be much higher.⁵⁰ Figure 1 illustrates the volume of loans that Superior securitized from 1993 until June 2000.

Figure 1: Volume of Loans Securitized Annually by Superior (000s omitted)



Source: Ernst & Young Audit Reports (6/30/93 – 6/30/00 *)
 * The years 1993 – 1999 include the entire year. The 2000 value only include the first 6 months of the year. Superior ceased securitizing loans as of June 30, 2000.

At first, Superior did not use FICO⁵¹ scores to assist in the assessment of the repayment ability of borrowers. Instead, Superior relied on internal classifications of borrowers based on the number of delinquencies, defaults, bankruptcies, or other similar characteristics. Later, when Superior incorporated FICO scores, the scores indicated a declining trend. OTS examiners stated that in 1999, the underwriting standards deteriorated in order to generate a greater volume of loans. Reportedly, Superior made efforts to tighten the lax standards in 1999; however, the increase in loan losses does not indicate that Superior was successful with this effort.

⁵⁰ A second mortgage is a mortgage that is subordinate to the lien created by a first mortgage. It is in effect, an installment loan secured by the borrower's real estate with a predetermined repayment table. Second mortgages are used for a variety of reasons including home improvement, investment in a business, and raising cash. If real estate has a first mortgage, the loan to value ratio is the amount owed divided by the value of the real estate. If the real estate has a first and second mortgage, the loan to value ratio increases due to the amount of the outstanding debt.

⁵¹ FICO is the Fair Isaac Company credit scoring. Credit scoring predicts the creditworthiness of credit applicants using a statistical model. Credit scoring estimates the repayment probability based on the information in the credit application and a credit bureau report.

OTS Placed Too Much Reliance on Superior's Management

As described earlier, two wealthy family groups purchased Superior Bank in 1988 through their holding company, Coast-to-Coast Financial Corporation (CCFC). They later incorporated additional entities under the CCFC umbrella, including a mortgage banking entity, which later became a division of Superior, and Fintek, Inc. (Fintek), a former capital markets group from another institution owned by one of the principals of CCFC. Fintek provided investment assistance to Superior and also performed the modeling to determine the market values for Superior's residual interests. The President of Fintek was a director of Superior and later became Superior's Chairman of the Board (Chairman). The Chairman had been involved with Superior since 1990. The Chairman's skills coupled with the retail banking experience of the Chief Executive Officer (CEO) and President, who was retained in 1993 for his retail banking expertise, prepared Superior to embark on its new business strategy of subprime securitizations. The following table indicates the compensation received by some of the highest-ranking officers at Superior.

Table 7: Superior Bank - Executive Officers' Compensation

Position *	1999	2000	2001
President	\$431,400	\$436,400	\$299,359
Executive Vice President	\$834,000	\$784,000	\$886,421
Senior Vice President	\$475,000	\$505,000	\$364,499
Senior Vice President	\$305,550	\$308,050	\$136,200

Source: OTS Examination Reports

* Total compensation includes salary, bonuses, awards, deferred compensation, executive performance program, director fees, auto allowances, country club dues, special awards, and relocation payments. The 2001 income includes compensation as reflected in the OTS's March 19, 2001 Report of Examination.

From the onset, the OTS considered the new management team and the Board of Directors to be capable managers, involved in the affairs of the institution and well informed. From discussions with OTS personnel, they believed that this group of individuals had the ability to manage and administer Superior's business activities. Also, because of their financial status, the OTS placed a great deal of reliance on the ability of the owners to inject capital if the institution encountered any financial difficulties. The owners were also averse to publicity, especially publicity that would sully their reputation. They were community oriented and saw the subprime lending area as a way to advance relations in their community. There were many individuals in Superior's immediate community who could be classified as subprime borrowers. Without the offering of these loans by Superior, they might be unable to obtain financing. Additionally, because of their wealth and stature in the community, the owners would be able to lend support to Superior as well as recruit competent individuals to administer the affairs of the bank.

The consensus of opinion among OTS personnel was that the owners and management were a group of reputable people. When the examiners criticized areas of the institution,

management was quick to respond with promises to take action. Even when the promises proved empty, the OTS still had faith and confidence in their ability. Even after the 2000 examination when the OTS examiners downgraded the institution to a composite “4,” OTS personnel still believed that management would be able to resolve the problems.

In the first quarter of 2001, the OTS designated Superior as significantly undercapitalized as of December 31, 2000 due to examination adjustments. Management filed the March 31, 2001 TFR and included three qualifying statements relating to the reported value of the residual interests, the capital contribution from CCFC, and the right of offset. (Refer to Topic 2 for a detailed discussion of the TFR adjustments.) The OTS objected to all three statements; however, the OTS did not require Superior to amend its TFR. This decision was due, in part, to the ongoing negotiations for the recapitalization plan and the OTS’s belief that the owners would make the institution whole.

Favorable Capital Ratio Calculations Enable Superior to Remain Above an Undercapitalized Category for PCA Purposes

At the conclusion of the 2000 examination of Superior and during the preliminary work prior to the start of the 2001 examination, the OTS computed the tax effect on loss classifications before calculating the capital ratios, which increased the capital ratios for PCA purposes. The OTS has not issued any guidelines stating whether this is a permissible activity or outlining circumstances when examiners may use discretion and recalculate the ratios by incorporating a tax effect on loss classifications. The incorporation of the tax effect on loss classifications resulted in higher capital ratios and a more favorable PCA classification for Superior. Since the capital ratios were higher by adjusting the capital deductions, Superior did not reach the critically undercapitalized category until July 2001.

Capital Ratio Calculations at the 2000 Examination

From 1991 until year-end 1999, the OTS assigned Superior either a composite “1” or a composite “2” rating. An examination was conducted with three FDIC representatives on January 24, 2000. Adversely classified assets increased substantially compared to the previous examination. There was notable loss experience in the automobile division and the ALLL was grossly overstated.⁵² Additionally, management was unable to support the assumptions used to value the residual interests, which would require a revaluation of the assets and a possible write-down. The following excerpt is taken from the January 24, 2000 OTS examination report.

Our findings reduced the capital designation of Superior from a “well capitalized” status, which it has maintained for the past several years, to an “adequately” capitalized status as of December 31, 1999. An “adequately

⁵² The overstatement of the ALLL in itself inflated the capital position since all or a portion of the ALLL, up to 1.25 percent of risk weighted assets, may be included in Tier 2 or supplemental capital. Tier 2 capital is the supplemental capital and consists of the ALLL, cumulative perpetual preferred stock, long-term preferred stock and related surplus, perpetual preferred stock where the dividend is reset periodically, hybrid capital instruments, and term subordinated debt and intermediate-term preferred stock.

capitalized” status is insufficient for Superior’s primary business activities. The current examination findings of significant write-offs and the addition of risk-weighted assets reduced the risk-based capital ratio from 10.79 percent to 7.81 percent as of December 31, 1999, prior to any tax considerations for the write-offs. The estimated risk-based capital ratio, after tax considerations, is 8.57 percent.⁵³

The FDIC OIG conducted interviews with OTS personnel ranging from field examiners to executive level personnel. When we asked if this type of pre- and post-tax calculation is performed at all OTS institutions, we received conflicting answers. We could not determine based on the varied responses if this calculation was only performed at Superior or if it was a common practice used at other institutions. Field examiners claimed that the calculation of losses on a pre- and post-tax basis was not done at the conclusion of examinations. In a December 21, 2001 letter from the Managing Director of Supervision of OTS, an explanation for this treatment was offered. He stated that the capital ratios reflected in the reports were in compliance with Generally Accepted Accounting Principles (GAAP). Additionally, this process of calculating the pre- and post-tax basis is done on a case by case basis at the OTS’s discretion. However, he did not produce any specific OTS guidance pertaining to this issue of calculating capital as requested in the letter. Also, OTS executive level personnel stated that “all regulatory agencies do this.” FDIC executive management as well as field examiners and case managers stated that the FDIC does not calculate examination losses on a post-tax basis. We did not survey the Office of the Comptroller of the Currency or the Federal Reserve Board to get their response to this query.

The October 2000 visitation was performed by the OTS with FDIC participation. The purpose of the visitation was to follow up on the January 2000 examination recommendations. The visitation results reflected that Superior’s management did not make all of the adjustments to capital recommended in the January 2000 examination report, such as charging off all assets classified loss. Additionally, numerous other deficiencies were noted during the visitation, including the misapplication of accounting principles to the OC account. The visitation report indicated that deficiencies noted in the previous report, which management indicated had been corrected, were still outstanding. The visitation report included a table detailing the calculation of capital including loss classifications using a pre- and post-tax basis. Although the capital ratios were not actually calculated in the report, using the numerical values in the table to calculate the values results in capital ratios detailed in Table 8 below.

⁵³ If the pre-tax capital calculation had been used, Superior would have been undercapitalized for PCA purposes.

Table 8: Calculation of Capital Ratios from the October 2000 Visitation of Superior

Capital Ratio	Pre-Tax calculation	Post-Tax Calculation
Total Risk-Based Capital	2.33%	5.20%
Tangible Capital	2.89%	7.19%
PCA Category Based on Capital Ratios	Significantly Undercapitalized	Significantly Undercapitalized

Source: OIG Analysis of data from the OTS 2000 Visitation Report

The visitation report notes that the tax effect was calculated based on a 39 percent tax rate. In fact, Superior was not making money and had no real income against which to offset the losses. There was no evidence that the FDIC objected or approved of the post-tax calculation.

The OTS and the FDIC returned to the bank to conduct an examination as of March 19, 2001. Although there were sizeable losses noted at the examination, it appears that all loss classifications were not deducted from capital in the March 2001 OTS draft examination report. The capital ratios are not reflected in the report with loss classifications on a pre- or post-tax basis. The FDIC draft report stated that if all loss classifications had been deducted from capital, the institution would have been insolvent as of this examination. A review of the OTS workpapers revealed several workpapers where the OTS examiners calculated the capital ratios on a pre- and post-tax basis. The following table details the ratios and the date on which they were calculated for Superior Bank using financial data as of December 31, 2000.

Table 9: Capital Ratios for Superior Bank as of December 31, 2000

Capital Ratio	Date of Calculation	Pre-Tax	Post-Tax
Total Risk-Based Capital	2/12/01	1.88%	4.36%
Tangible Capital	2/12/01	2.42%	5.94%

Source: OTS Examination Workpapers

A July 24, 2001 memo to the Docket File from the OTS Regional Deputy Director, 3 days prior to the closing of the institution, relates the results of the March 19, 2001 examination. The memo states in part:

Based upon that reconciliation (between the examination findings and the March 31, 2001 TFR), when applying the examiners' findings, the total equity capital position of Superior is a negative \$125.6 million. Superior was not required to make these adjustments due to the Capital Plan conditionally approved by the OTS on May 24, 2001. The shareholders failed to implement the Capital Plan by the implementation date of July 23, 2001, and therefore, the examiners' adjustments must be made.

The July 25, 2001 version of the capital ratios is detailed in the following table.

Table 10: Capital Ratios for Superior as of July 25, 2001

Capital Ratio	Superior's 3/31/01 calculation	After Examination Adjustments 3/31/01
GAAP Equity	3.15%	(7.16%)
Total Risk-Based Capital	1.47%	(7.18%)

Source: OTS Examination Workpapers

We interviewed the OTS's Chief Accountant on the subject of computing a tax effect on loss classifications in order to recalculate the capital ratios. He stated that calculating the tax effect may be proper; however, in an institution as complicated as Superior, this calculation should not be performed using an effective tax rate. When we reviewed the OTS workpapers, we concluded that the calculations for the December 31, 1999 pre- and post-tax calculations in the January 2000 Report of Examination were performed using an effective tax rate. Consideration was not given to whether the institution was in a position to derive any tax benefit from the transactions even though one workpaper prepared by the regional accountant recommended that the pre-tax ratio be used since Superior's ability to continue as a going concern was questionable. In fact, Superior was not making money and had no real income against which to offset the losses. Accordingly the "post-tax" rate was invalid and should not have been used.

Additionally, we consulted with an FDIC DOS specialist concerning the inclusion of tax affecting loss classifications for determining regulatory capital ratios. His response included the following statements:

The banking agencies adopted GAAP as the reporting basis for recognition and measurement purposes in the balance sheet, income statement, and related Call Report schedules in 1997. Then-existing Call Report instructions that departed from GAAP were revised to bring them into conformity with GAAP. However, as the FFIEC and the agencies stated in the attachment to FIL-109-96, dated December 31, 1996, which notified banks about the Call Report revisions taking effect in 1997 adopting GAAP as the reporting basis in the basic schedules of the Call Report will eliminate existing differences between bank regulatory reporting standards and GAAP, thereby producing greater consistency in the information collected in regulatory reports and general purpose financial statements and reducing reporting burden. However, bank regulatory capital ratios will continue to be calculated in accordance with the agencies' capital standards.

For examination purposes, when examiners calculate capital ratios as of the examination date and deduct assets classified loss and make deductions from capital for other identified losses, they do not adjust these deductions for any tax effects. Rather, if an institution needs to submit a Capital Plan because it needs to increase capital to some specified level, the institution's plan can show the actual effect on capital of whatever charge-offs and write-downs it is taking or

has taken in response to the examination findings, including any related tax effects, along with the other actions the institution plans to take in order to reach the specified capital level.

However, we saw no evidence that the FDIC objected or approved of the post-tax calculation.

Comments on Notice of Final Rulemaking Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Residual Interests in Asset Securitization or Other Transfers of Financial Assets

In the Pacific Thrift and Loan Company Material Loss Review,⁵⁴ we recommended that the FDIC and the other federal banking regulators continue to pursue amending the capital standards to exclude residual interests based on subprime securitizations from the calculation of capital. A proposed capital standard was issued in 2000 that placed limitations on the amount of residual interests that can be held by insured depository institutions without incurring additional capital charges. Also, the proposal specifies the amount of capital that must be retained for institutions that exceed these limitations. On November 29, 2001, the federal banking authorities announced the publication of a final rule for the revision of the capital standards addressing limitations and capital charges for insured depository institutions that engage in securitization activities.

New Rule to Amend the Regulatory Capital Treatment of Residual Assets

On November 29, 2001 the federal bank and thrift regulatory agencies issued a new rule that changes, among other things, the regulatory capital treatment of residual interests in asset securitizations. The rule, which became effective on January 1, 2002, addresses the concerns associated with residuals that exposed financial institutions like Superior Bank to high levels of credit and liquidity risk. Under the new rule, capital treatment for residual interests would:

- Limit credit enhancing interest-only strips, a form of residual interest, to 25 percent of Tier 1 capital for regulatory capital purposes,
- Require banking organizations to deduct credit-enhancing interest-only strips that are in excess of 25 percent of Tier 1 capital from Tier 1 capital and from assets and to maintain risk-based capital in an amount equal to the face amount of residual interests that do not qualify for the ratings-based approach, and
- Apply a ratings-based approach that sets the capital requirements for asset- and mortgage-backed securities and other positions in securitization transactions (except for credit-enhancing interest-only strips) according to their relative risk using credit ratings from rating agencies to measure the level of risk.

⁵⁴ FDIC OIG's June 7, 2000 Audit Report No. 00-022 *Material Loss Review – The Failure of Pacific Thrift and Loan Company, Woodland Hills, California.*

The dollar for dollar capital requirement, in tandem with the concentration limit will help to ensure that adequate risk-based capital is held against residuals and will limit the amount of residuals that could be recognized for regulatory capital purposes. In our opinion, had Superior Bank operated in accordance with this new rule, it would not have incurred the losses it did and may have avoided failure.

Topic 5 - The effectiveness of the regulators' onsite examination and offsite monitoring of Superior Bank in detecting the institution's problems at an early stage.

From 1993 to 1999, the Office of Thrift Supervision's (OTS) onsite examination and offsite monitoring of Superior was not effective. While OTS examiners were able to identify management's banking activities and to quantify the extent to which these activities impacted the financial statements, OTS did not fully assess all of the risks to the institution. As a result, effective supervisory action was not implemented. In particular, high-risk indicators that warranted further investigation existed early on, but were either not identified, were not followed-up at subsequent examinations, or were not fully addressed by OTS's onsite examination and offsite monitoring processes. Of particular concern were high-risk indicators that eventually led to the failure of the institution. The Federal Deposit Insurance Corporation's (FDIC) onsite examination participation during the January 24, 2000 and March 19, 2001 safety and soundness examinations helped to identify weaknesses and problems within the institution. In addition, the FDIC's offsite monitoring of Superior was effective in detecting potential areas of concern with the institution.

The Board of Directors' Oversight of the Institution

From 1993 to 1999, the Office of Thrift Supervision's (OTS) overall effectiveness in detecting and addressing issues concerning Superior's Board of Directors was limited. The Federal Deposit Insurance Corporation's (FDIC) Division of Supervision (DOS) Manual of Examination Policies states that "the quality of management, which includes the Board of Directors, is probably the single most important element in the successful operation of a bank. In particular, it is extremely important for all members of bank management to be aware of the responsibilities entrusted to them and to discharge those responsibilities in a manner that will ensure the stability and soundness of the institution. In the broadest sense, the board is responsible for the formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. While the selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability, and vigor of the bank are dependent upon an interested, informed, and vigilant Board of Directors." The monitoring, review, and assessment of management adequacy is a very complex and subjective process that interrelates with all of the other rating components used in assessing an institution's performance.

At Superior, several high-risk indicators were present and included the following:

- The domination of affairs of the institution by one individual, the Chairman of the Board.
- The failure to establish adequate policies and procedures. In particular, the board did not impose a capital limitation on the amount of residual assets⁵⁵ that could be recorded on the bank's books; the board allowed management to value residual interests based on liberal and unrealistic assumptions; the board did not adopt interagency policy guidelines; the board allowed excessive dividends to be declared and paid; and the board did not adequately protect the institution with sound capital levels.
- The failure to address supervisory recommendations and criticisms. The board did not ensure that corrective action had been properly implemented. As noted above, the board did not ensure that corrective action had been properly implemented in establishing capital limitations, adopting interagency policy guidelines, and preventing excessive dividends. In addition, the board did not ensure that corrective action had been accurately and properly implemented in the submission of Thrift Financial Reports (TFR). Specifically, the board did not ensure that the TFR accurately and properly identified and charged-off adversely classified assets, accounted for the allowance for loan and lease losses, risk-weighted assets for risk-based capital purposes, and accounted for residual interests.
- The failure to ensure adherence to laws and regulations. The board allowed prohibited transactions with affiliates to be conducted.

While all of the above concerns are discussed elsewhere in this report, the OTS's overall effectiveness in detecting and addressing these items as supervisory concerns was limited until the January 24, 2000 Report of Examination (ROE), which was conducted with the FDIC's participation.

Automobile and Mortgage Securitization Activities

Several high-risk indicators were not appropriately addressed or reviewed by OTS. These high-risk indicators included the following:

- the reliance on imputed gains to support earnings and to justify the payment of dividends,
- the level of capital in comparison to (1) the peer group averages and regulatory capital definitions, (2) the risk profile of the institution, (3) the concentration of residual assets, and (4) the reasonableness of dividend payments,
- the valuation of the residual interests and the overcollateralization (OC) accounts,

⁵⁵ The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

- the lack of adoption and adherence to interagency policies and procedures, and
- the initiation of new bank activities.

Each of these high-risk indicators is discussed within the following sections.

Earnings

For all ROEs issued on Superior since 1993, OTS did not fully analyze and assess the potential impact of imputed gains on earnings⁵⁶ and to the institution. Specifically, imputed gains are generated from the sale of securitized loans, and the calculations used to measure those gains are based on various assumptions and estimates that are subject to change. While OTS identified the volume of imputed gains recorded and noted that the gains were unrealized and subject to change, the OTS did not analyze and assess the bank's performance without those gains or on a realized cash flow basis. In effect, OTS gave undue reliance to non-interest income that was nonrecurring,⁵⁷ unrealized, and subject to significant market and economic volatility. Furthermore, OTS assessed the reasonableness of dividends based on the amount of net income, which included the imputed gains recorded into income. OTS did not assess the reasonableness of dividends based on the nature and extent that imputed gains were actually realized by the bank on a cash flow basis.

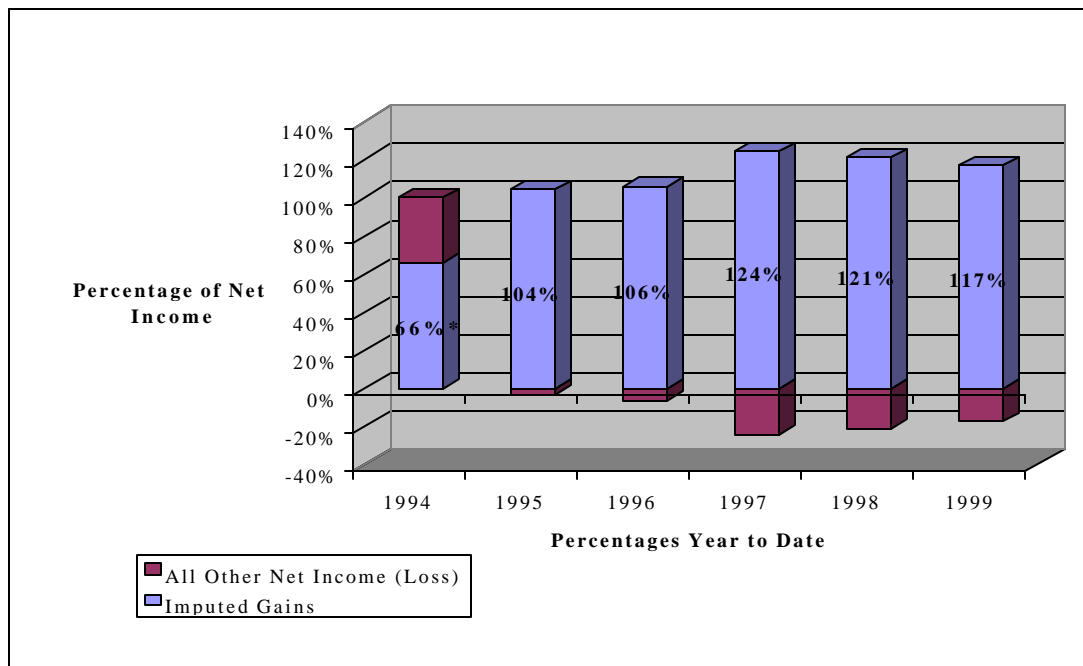
The volume of imputed gains represented a significant portion of the bank's net income. In particular, imputed gains represented over 120 percent of total net income in 1997 and 1998. If these gains were excluded, the bank would have recognized a net loss in each year since 1995. Furthermore, based on the bank's dividend policy that allowed 50 percent of net income to be allocated to the holding company, cash dividends of \$36.6 million and \$56 million were declared and recorded during 1997 and 1998, respectively. As a result, if the imputed gains were not fully realized, the dividends distributed to the holding company could erode the bank's capital position.

⁵⁶ In accordance with the Report of Examination instructions, "Quality and quantity of earnings are evaluated in relation to the ability to provide for adequate capital through retained earnings; level, trend, and stability of earnings; sources of earnings; level of expenses in relation to operations; vulnerability of earnings to market risk exposures; adequacy of provisions to maintain the allowance for loan and lease losses and other valuation reserves; reliance on unusual or nonrecurring gains or losses; the contribution of extraordinary items, securities transactions, and tax effects to net income; and adequacy of budgeting systems, forecasting processes, and management information systems."

⁵⁷ The OTS Regulatory Handbook describes nonrecurring sources of income as gains on the sale of assets that are generally unpredictable and unstable. The FDIC DOS Manual of Examination Policies recognizes that the quality of earnings can be diminished by undue reliance on nonrecurring events. In particular, short-term earnings performance can be enhanced by recording current period gains that are generated by the liquidation of high-yielding assets at the expense of future income potential. As a result, the level and trend of earnings could be quite positive; however, future income potential may be sacrificed if funds can only be reinvested at a lower rate of return (or in riskier assets). While Superior's securitization activities made the selling of loans and the recognition of imputed gains recurring events, and a main source of income, in a traditionally run financial institution the liquidation of a loan portfolio would have been considered a nonrecurring transaction that is unusual in nature or infrequent in occurrence. Traditionally, financial institutions generate loans and hold them to maturity, and the main source of income is generated by the interest earned on loans and securities.

Figure 2 illustrates the percentage of imputed gains to net income (before tax) from 1994 to 1999. The figure does not include the bank's performance for the year ended 2000 and for the two quarters ended June 2001, because the bank reported net losses of \$11.2 million and \$104.8 million which used up the recorded imputed gains of approximately \$43.4 million and \$0.473 million respectively. Table 11 presents the monetary impact that imputed gains had on net income, and the table presents the percentage of imputed gains needed to be fully realized in order to avoid capital depletion based on the adjusted level of net income and distributed dividends. For analysis purposes, this percentage is similar to a break-even ratio. However, this ratio does not factor in the amount of imputed gains needed to be realized in order to maintain a proportionate level of capital to assets, which can be significant in an institution with a high level of growth. In addition, the table does not show how much the imputed gains were overvalued. This information cannot be determined or estimated based on the data available nor based on the analysis performed within the OTS's ROEs and the FDIC's memorandums to the bank file. However, the assets associated with the generation of the imputed gains, the residual interests and OC accounts, were ultimately written down by \$420 million. The OC account was written down by \$270 million to correct an accounting error, and the residual interests account was written down by \$150 million to correct the use of liberal assumptions in its computation. For both the figure and the table, the information presented is based on the bank's financial performance before taking into consideration tax consequences. This was done to simplify the analysis and to avoid complications associated with the bank's tax structure.

Figure 2: Imputed Gains as a Percentage of Net Income (Before Tax)



Source: OIG Analysis of the Thrift Financial Reports

* Excluding imputed gains, 1994 was the only year that the bank would have recognized a positive level of earnings.

Table 11: Impact of Imputed Gains on Net Income and Dividends Paid

Calendar Year	Net Income - Includes Imputed Gains (Before Tax) (000's) A	Imputed Gains** (Before Tax) (000's) B	Net Income Less Imputed Gains (Before Tax) (000's) A-B = C	Dividends Paid (000's) D	Percentage of Imputed Gains Needed to Avoid Capital Depletion (D-C)/B = E
1994	\$ 10,915	\$ 7,153	\$ 3,762	\$ *5,793	28%
1995	30,053	31,128	(1,075)	*11,655	41%
1996	60,035	63,535	(3,500)	35,291	61%
1997	73,501	91,314	(17,813)	36,556	60%
1998	113,235	137,103	(23,868)	56,022	58%
1999	159,366	185,979	(26,613)	*33,556	32%

Source: OIG Analysis of Thrift Financial Reports and Reports of Examination

* Amounts include cash and non-cash dividends

** Imputed Gains were reported in the Thrift Financial Reports on the line item entitled "Sale of Assets Held for Sale and Available-for-Sale Securities." This line item was used to establish the dollar volume of imputed gains.

The OTS examiners and supervisors we interviewed justified the examination review and treatment of the imputed gains based on the following:

- The bank's securitization activities were a major focus of business operations,
- Generally Accepted Accounting Principles (GAAP) allowed the recognition of imputed gains into earnings, and
- OTS's Capital Markets Specialist endorsed the assumptions and computations that derived those gains.

In particular, the Field Manager stated, in part, that he would not change the analysis that he or his examiners performed, and that he felt the analysis was accurate and valid. He also stated that he was comfortable with Superior's earnings and that he recognized them as solid. He asserted that the examiners and Capital Markets Specialist did their jobs in reporting the level of activity. Furthermore, he stated that at that time (1996 to 1999), it was their opinion that the bank was complying with the regulations and accounting guidelines, and he did not see any reason why the dividends should not have been approved by the OTS regional office. The Field Manager also clarified that he had nothing to do with the approval of dividends and that the approval process was a function performed by the regional office.

Since 1994, four OTS examiners filled the position of Examiner-in-Charge of seven different full-scope safety and soundness examinations. Collectively, the examiners stated that their rating of earnings was based on the fact that securitization activities were a major part of the bank's business, that the valuation assumptions on the residual interests were endorsed by OTS's Capital Markets Specialists, that reliance was placed on the accountants for what was acceptable reporting, and according to GAAP the bank was allowed to record profits from the sale of loans. In terms of dividend distributions,

one examiner stated that if a bank is issuing dividends within its guidelines, then the examiners do not make an issue out of it. The examiner also stated that the Deputy Regional Director approves dividend distributions and that the field does not approve them.

Despite the above comments, it was still the agency's supervisory responsibility to evaluate imputed gains and dividends and to assess their potential impact on bank operations. In addition, OTS's Regional Deputy Director agreed that a more critical assessment of imputed gains should have been performed. Of particular note, the OTS recommended within the July 6, 1993 ROE that the bank develop a comprehensive dividend policy that considered the impact on capital from those assets (gains) created by the securitization and sale of loans. However, this recommendation was not implemented by the institution, nor did OTS formally follow up and reiterate this recommendation in subsequent examination reports.

The OTS Handbook instructs supervisory personnel to evaluate earnings and its components in relation to their stability,⁵⁸ trend,⁵⁹ and level.⁶⁰ The OTS Handbook recognizes that in assessing the stability of earnings, recurring income sources, such as net interest on loans or investment portfolios, are usually preferable to nonrecurring income sources, such as income derived from the sale of assets. The OTS Handbook further states that a savings association's future viability could be severely affected if it relies too heavily on nonrecurring sources of income. The Operations Analysis Program contained within the OTS Handbook also instructs examiners, in part, to evaluate the composition of earnings, taking into consideration recurring and nonrecurring income sources, and to consider the effect on future earnings potential. OTS's examination reports, going back to 1993, do not reflect the impact of these identified concerns and risks.

The *Interagency Guidance on Asset Securitization Activities*,⁶¹ dated December 13, 1999, highlights that imputed gains resulting from residual interests are subject to significant market and economic volatility. The guidance notes that unforeseen market events can affect the discount rate or performance of receivables supporting residual interests, which can swiftly and dramatically alter the value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate

⁵⁸ Stability is defined as the quality, composition, and constancy of income and expense flows relative to internal factors such as credit risks, interest rate risks, or accounting practices, and external factors such as general economic or competitive forces.

⁵⁹ Trend is defined as the general direction of the savings association's earnings relative to previous time periods.

⁶⁰ Level of earnings is defined as the measure of earnings relative to internal factors such as capital position, credit risk, and interest rate risk.

⁶¹ This securitization guidance issued by the OCC, FDIC, FRB, and OTS highlights the risks associated with asset securitization and emphasizes the regulators' concerns with certain residual interests generated from the securitization and sale of assets. This guidance supplements existing policy statements and examination procedures issued by the federal banking agencies and emphasizes the specific expectation that any securitization-related residual interests claimed by a financial institution will be supported by documentation of the interest's fair value, utilizing reasonable, conservative, valuation assumptions that can be objectively verified.

“paper profits” or mask losses through flawed assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, substantial write-downs of residual interests and, if these interests represent an excessive concentration of the institution’s capital, the demise of the sponsoring institution.

The interagency guidance recommends, among various analyses, that a periodic Static Pool Cash Collection Analysis be performed. This analysis entails reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. The interagency guidance also recommends that a comparison be performed of the timing and amount of cash flows received from the trust with those projected as part of the Financial Accounting Standards (FAS) 125 residual assets valuation analysis on a monthly basis. The guidance stipulates that this analysis is essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. In particular, if cash receipts are less than those assumed in the original valuation of the residual interests, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the residual interests.

While OTS’s supervisory personnel understood that the imputed gains represented a significant part of net income, were unrealized, and were subject to change, an assessment was not made of the potential impact to the institution should those imputed gains fail to be fully realized. In interviews with OTS’s Field Manager and examiners, they did not recognize the need for this analysis. The lack of a proactive review and analysis of the imputed gains resulted in an implied acceptance of the adequacy of the income stream’s quality and stability, which resulted in the failure to recommend policy and procedural enhancements that would have limited or mitigated the identified risk. Despite the lack of realized gains, total dividends declared and paid by the institution exceeded \$200 million from 1992 to 2001.

Capital Levels

For all ROEs issued on Superior, OTS did not fully analyze and assess the bank’s capital adequacy.⁶² While OTS supervisors routinely identified the level and trend of capital, certain areas of concern were not fully addressed. In particular, the bank’s risk-based

⁶²In accordance with the Report of Examination instructions, “Capital adequacy is evaluated in relation to supervisory guidelines; the nature and extent of risks to the organization, and the ability of management to address these risk; consideration is given to the level and quality of capital and overall financial condition of the institution; the nature, trend and volume of problem assets and the adequacy of the allowance for loan and lease losses and other valuation reserves; risk exposures presented by off-balance sheet activities; quality and strength of earnings; balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and nontraditional activity risk; growth experiences, plans, and prospects; reasonableness of dividends; access to capital markets and other appropriate sources of financial assistance; and ability of management to address emerging needs for additional capital.”

capital ratio⁶³ remained below peer levels, capital calculations were not consistently reviewed and enforced, and significant capital concentrations existed. In addition, the reasonableness of dividends was not assessed based on the nature and extent of imputed gains that were recognized as earnings. (Refer to Topic 7 for additional information on the dividend payments.) Furthermore, the supervisory analysis conducted at this institution supported capital adequacy based on the bank's commitment to maintain and adhere to the regulatory capital definitions. In effect, OTS did not require or evaluate this institution's capital adequacy based on the institution's particular risk profile, and capital was not maintained commensurate with the institution's level and nature of risk exposure.

In assessing capital adequacy, OTS supervisory personnel consistently identified that the institution's tangible and core capital ratios exceeded its peer group median, while the risk-based capital ratio remained below the peer average. While OTS identified that the risk-based capital ratio was below the peer group median, the significance of this ratio was not emphasized in evaluating capital adequacy. In particular, this ratio is a measure of the level of capital available based on the risk profile of an individual bank. Conversely, OTS emphasized the significance of the tangible and core capital ratios, which indicates the extent to which capital was leveraged. However, these two ratios (tangible and core) fail to reflect the risk associated within the bank's asset structure and more specifically within the residual assets. Furthermore, all three ratios (tangible, core, and risk-based) are subject to overvaluation and manipulation by potentially liberal assumptions used in calculating and valuing the residual interests and OC accounts. In addition, these ratios do not take into consideration the additional capital needed to protect the institution against the risk created from the bank's unique risk profile, which included, among other things, the presence of a high capital concentration level of residual assets and significant subprime⁶⁴ lending activities.

Table 12 below details the bank's capital ratios in comparison to peer averages as presented in the ROEs since 1996. These ratios are presented as they were detailed within OTS's ROEs. The ratios were not readjusted to capture any subsequent correction to the bank's financial statements that were identified at later examinations. As can be expected, if the changes in estimated asset values and the identification of accounting errors were identified and applied in an earlier period, the value of the bank's assets and the amount of capital would decrease. As a result, the bank's risk-based capital ratio would fall further below the peer average, as was eventually recognized in the financial statement dated March 31, 2001.

⁶³ The risk-based capital ratio is calculated by dividing an institution's qualifying total capital base by its risk-weighted assets. The risk-weighted assets are calculated by assigning assets and off-balance sheet items into broad risk categories. The risk weightings range from 0 percent (for assets backed by the unconditional full faith and credit of the United States), to 100 percent (for many types of assets not qualifying for more favorable risk weighting). Off-balance sheet commitments are converted to "credit equivalent" amounts by a conversion factor. The credit equivalent amounts are then risk weighted in accordance with the rules used for balance sheet assets.

⁶⁴ The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgements, or bankruptcies. These borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

Table 12: Bank Versus Peer Average Capital Ratios

Financial Statement Date	Tangible and Core Capital Ratios*		Risk-Based Capital Ratio	
	Bank	Peer	Bank	Peer
03/31/01	2.2%	7.4%	1.5%	11.7%
12/31/99	10.5%	7.6%	7.8%	11.7%
12/31/98	12.0%	7.6%	10.0%	12.6%
09/30/97	12.9%	7.2%	10.7%	13.0%
06/30/96	10.2%	7.3%	11.2%	14.2%

Source: Reports of Examination and Uniform Thrift Performance Report

* Tangible and Core Capital Ratios were the same in all periods.

Moreover, capital calculations were not consistently reviewed. In the August 8, 1994 and the September 11, 1995 ROEs, OTS examiners notified Superior’s management of errors in the capital calculations. Specifically, the 1994 ROE cited the bank for including an allowance for investment loss in the supplemental section of risk-based capital. The amount was attributed to excess mortgage servicing rights and was documented as not being eligible for risk-based capital purposes. This issue was noted again during the 1995 examination and OTS repeated the criticism. However, after the 1995 examination, the bank still did not initiate corrective action, and OTS did not follow up to ensure corrective action had been taken. During the January 24, 2000 examination, OTS found again that the bank was using an allowance in the valuation of the residual assets and was inappropriately including the amount in supplemental capital. Furthermore, at this examination OTS also began to question management’s ability to substantiate the existence of this allowance. The failure to review and address prior examination criticisms and recommendations appears to be an error in the oversight process. The OTS Regulatory Handbook requires, and supervisory personnel interviewed stated, that prior examination criticisms should be followed up and reviewed at the subsequent examination.

Significant capital concentrations existed. (Refer to Topic 2 for additional information on the level of concentrations of residual assets.) As these concentrations grew, the examiners did not criticize the concentration’s size, and no recommendations were made to limit further growth. Only in the August 8, 1994 ROE did examiners note and recommend corrective action for the lack of a limitation on excess mortgage servicing rights investment levels. Although the OTS discussed the volume of securitization and residual assets at subsequent examinations, no specific criticisms were made and no recommendations were presented to limit the level of investment in these assets or to follow up on the recommendation made in the 1994 ROE.

In interviews with OTS’s examiners and other supervisory personnel, several individuals stated that they did not identify the concentration level as a concern, nor was it their responsibility to determine or to recommend that a concentration limitation be placed on an institution or to stipulate that more capital was needed. In particular, the OTS Field Manager stated, in part, that OTS had identified the concentration, but they had not formulated any concerns. He stated that there was no reason to curtail the bank’s activities in 1996 and 1997, the bank was making “big money,” and it was not until 1999

that the concentration level became an issue. Regardless, the Field Manager stated that the bank was a unique institution and that was how it chose to make its money, and OTS felt comfortable with what the bank was doing. Conversely, in an interview, the OTS Capital Markets Manager stated that he felt capital was insufficient based on the bank's activities and risk profile. However, he stated it was not his responsibility to assess capital, nor was it his responsibility to report his concerns to others. The Field Manager, however, did state that he had a conversation with the Capital Markets Manager, but he could not recall the details. Regardless, the Field Manager mirrored the Capital Markets Manager's statements by stating that no one was going to request more capital, because examiners don't have any "black and white" methodology to say how much capital is needed. He further clarified that it was not his, the Capital Markets Manager's, or the examiners' responsibility to say if a bank needs more capital, because they have nothing to "hang their hat on," and they don't know how much. However, they do determine the adequacy of capital. He also stated that he and the examiners set the ratings and Washington could have changed them, but no one was willing to make the statement that capital was less than adequate or insufficient. One examiner also stated that the examiners' responsibilities end with a discussion of the concentration in the ROE and that any final decisions or actions are up to the regional office. However, the *Interagency Guidance on Asset Securitization Activities*, dated December 13, 1999, stipulates that "consistent with existing supervisory authority, the agencies may, on a case-by-case basis, require institutions that have high concentrations of these assets (residual interest) relative to their capital...to hold additional capital commensurate with their risk exposures." The interagency guidance also emphasizes the need for internal limits to be put into place to govern the maximum amount of residual assets as a percentage of total equity capital.

Capital adequacy was routinely supported by the bank's adherence to regulatory capital definitions as an indicator of capital adequacy. In particular, OTS utilized minimum leverage and risk-based capital standards and the "well capitalized" and "adequately capitalized" definitions that are used in the Prompt Corrective Action regulations to support the assessment of capital adequacy. This treatment is supported, in part, by OTS's Regulatory Handbook that stipulates that meeting regulatory capital requirements is a key factor in determining capital adequacy. However, OTS's guidance also stipulates that the institution's operations and risk position may warrant additional capital beyond the minimum regulatory requirements, and examiners are directed to determine whether capital is adequate in relation to the risk profile and operations of the bank. The FDIC's DOS Manual of Examination Policies also recognizes a distinction in what is adequate capital for safety and soundness purposes versus adherence to regulatory minimum leverage and risk-based standards. The FDIC recognizes that the minimums set forth in the leverage and risk-based capital standards apply to sound, well-run banks, and that most banks are generally expected to maintain capital levels above the minimums, based on the institution's particular risk profile.

Based on interviews, an over-reliance existed on the owners' ability to provide additional support if needed; however, this view was not formally presented within the ROEs as a mitigating factor except to the extent that management intended to maintain a "Well

Capitalized” position. In addition, this assumption was never supported by the actions of the owners. In fact, professional skepticism should dictate that reliance on the owners would only be justified if similar actions had been demonstrated previously. Secondly, some examiners stated that they did not feel it was their place to recommend a capital concentration limitation or to require a capital injection. However, this view appears to go against the basic philosophy and supervisory responsibility that all regulators hold to assess the safety and soundness of institutions. Lastly, the level of understanding and comprehension of the nature of risk evident in the risk-based capital ratio, capital concentrations, and dividend payments may have been a factor. OTS’s supervisory personnel did not fully analyze and assess the risk to capital and to the institution, because of a general lack of awareness and knowledge of the need to proactively identify, measure, assess, and limit/mitigate potential risk to an institution.

Regardless of whether OTS over-relied on management’s assertions, did not take responsibility for criticizing concentration and capital levels, or did not have a full level of understanding and comprehension of the nature of risk present, OTS allowed risk-based capital levels to remain below the bank’s peer group median. If, at a minimum, OTS had required risk-based capital to increase to a level commensurate with the bank’s peer average, the bank would have needed to significantly increase capital. At a minimum, the additional level of capital needed as of December 31, 1999, would have equaled a range from 16.0 percent to 19.8 percent of the estimated losses to the insurance fund of \$426 million to \$526 million as of the date of closure. The minimum required capital injections are presented below, in Table 13, as of the financial statement date. This comparison, however, is based on the bank’s peer group which is largely composed of financial institutions that are traditionally run, possess lower risk profiles, and do not have high concentrations in high-risk assets. The presence of these additional risk factors in Superior was not captured by the risk-based capital ratio and should have prompted even greater increases in capital levels. For example, based on comments made by Director Reich in an article entitled *FDIC Head: Superior’s Lessons Are Old Ones*, dated August 21, 2001, the average common equity capital ratio for non-bank subprime lenders equaled 22.5 percent in 1998. Director Reich noted that this level of capitalization occurs because market pressures force non-bank lenders to hold more reserves in order to attract investments. Furthermore, the analysis presented below also assumes that all of Superior’s assets were accurately valued and accounted for as presented in the ROEs. By increasing the institution’s expected level of capital, OTS could have halted dividend payments and slowed the growth of the institution, which would have also limited the losses to the deposit insurance fund.

Table 14 illustrates the impact on dividends that would have occurred if the bank had been expected to maintain the risk-based capital ratio at a level equal to its peer group average and at 300 basis points above its peer group average. As the data shows, dividends could have been halted in 1996 and substantially reduced thereafter. Furthermore, if this analysis was coupled with the analysis discussed earlier on earnings and imputed gains, any payment of dividends could have been deferred until the imputed gains were realized on a cash flow basis. While an analysis of when the imputed gains were realized was not performed due to the lack of available information, a deferment of

one year on the 300 basis point increase scenario and a deferment of two years on the minimum capital scenario would effectively support halting all dividend payments. The safety and soundness examinations conducted in 1994 and 1995 were excluded from the tables below due to the lack of a quoted peer risk-based capital ratio within OTS's ROEs.

Table 13: Minimum Capital Shortfall Based on the Risk-Based Capital Ratio Differential

Financial Statement Date	Risk-Based Capital Ratio		Ratio Differential A-B = C	Total Assets (000's) D	Capital Shortfall (000's) C*D = E
	Bank A	Peer B			
03/31/01	1.5%	11.7%	(10.2%)	\$ 1,941,439	\$ 198,027
12/31/99	7.8%	11.7%	(3.9%)	2,161,443	84,296
12/31/98	10.0%	12.6%	(2.6%)	1,801,705	46,844
09/30/97	10.7%	13.0%	(2.3%)	1,184,351	27,240
06/30/96	11.2%	14.2%	(3.0%)	1,037,609	31,128

Source: OIG Analysis of OTS Reports of Examination

Table 14: Capital Shortfall Comparison to Dividends Paid

Financial Statement Date	Minimum Capital Shortfall (000's) A	Capital Shortfall Based on a 300 Basis Point Increase Above Peer Ratios (000's) B
03/31/01	\$ 198,027	\$ 256,269
12/31/99	84,296	149,139
12/31/98	46,844	100,895
09/30/97	27,240	62,770
06/30/96	31,128	62,256

Calendar Year	Dividends Paid (000's) C	Cumulative Dividends Paid Since 1996 (000's) D	Cumulative Dividends Available Based on Minimum Capital Shortfall (000's) D-A = E	Cumulative Dividends Available Based on Capital Shortfall – 300 Basis Point Increase Above Peer Ratios (000's) D-B = F
2000 & 2001	\$ 0	\$ *161,425	\$ (36,602)	\$ (94,844)
1999	*33,556	*161,425	77,129	12,286
1998	56,022	127,869	81,025	26,974
1997	36,556	71,847	44,607	9,077
1996	35,291	35,291	4,163	(26,965)

Source: OIG Analysis of OTS Reports of Examination

* Amount includes cash and non-cash dividends.

The Valuation of Residual Interests and the Overcollateralization Accounts

OTS's early onsite examination and offsite monitoring processes used to detect problems in the valuation of residual interests and in the OC accounts were not effective. As discussed elsewhere in this report, OTS over-relied on management assurances and on

Superior's external auditor's opinions when assessing the value of the bank's residual interests and OC accounts. (Refer to Topic 3 for a detailed discussion of Ernst & Young.) When Superior began the securitization process, OTS reported on the bank's valuation assumptions during their safety and soundness examinations. In 1996, the OTS brought in a Capital Markets Specialist from the Southeast Region to review all of the bank's residual assets. Based on this review, the ROE did not note any deficiencies with the assumptions that Superior was using to value the residual interests. Furthermore, the two subsequent examinations also did not note any deficiencies. However, the documentation used to support, and the examination methodology used to substantiate management's assumptions, were not detailed within the ROEs. Following the January 25, 1999 examination, Superior clearly liberalized its assumptions, which increased the value of the residual interests. Both the FDIC and the OTS participated in the January 24, 2000 examination, and both agencies criticized Superior's unsupported assumptions. It is unclear how these liberal assumptions were supported and whether they were implemented with or without the board's approval. Furthermore, it is unclear how the bank's policies, procedures, or processes changed from what had been done in the earlier years due to the lack of detail provided in OTS's ROEs.

Interagency Policies and Procedures

Superior began the automobile loan program in 1994. However, for all ROEs issued on Superior from 1994 to 1999, OTS identified the level and trend of loan underwriting and asset securitization activities, but adherence to the standard interagency policy guidance was not enforced. OTS did not enforce the *Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status*, (1980 Policy) issued June 30, 1980,⁶⁵ and OTS did not fully enforce the *Uniform Retail Credit Classification and Account Management Policy* (Uniform Policy) issued February 10, 1999,⁶⁶ and the

⁶⁵ On June 30, 1980, the FRB, FDIC, and OCC adopted the Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status (1980 Policy). The Federal Home Loan Bank Board, the predecessor of the OTS, adopted the 1980 policy in 1987. The 1980 policy established uniform guidelines for the classification of retail installment credit based on delinquency status and provided charge-off time frames for open-end and closed-end credit. The 1980 Policy required examiners to follow the general classification policy during examinations of commercial banks:

- Closed-end consumer installment credit delinquent 120 days or more (5 monthly payments) will be classified Loss, and loans delinquent 90 to 119 days (4 monthly payments) will be classified Substandard.
- Open-end consumer installment credit delinquent 180 days or more (7 zero billing cycles) will be classified Loss, and loans delinquent 90 to 179 days (4 to 6 zero billing cycles) will be classified Substandard.

⁶⁶ On February 10, 1999, the banking agencies issued the Uniform Retail Credit Classification and Account Management Policy (Uniform Policy). In general, the Uniform Policy:

- Established a charge-off policy for open-end credit at 180 days delinquency and closed-end credit at 120 days delinquency.
- Provided guidance for loans affected by bankruptcy, fraud, and death.
- Established guidelines for re-aging, extending, deferring, or rewriting past due accounts.
- Provided for classification of certain delinquent residential mortgage and home equity loans.
- Provided an alternative method of recognizing partial payments.

revisions to the Uniform Policy (Revised Policy) issued June 12, 2000.⁶⁷ The Uniform Policy was first utilized during the January 24, 2000 OTS safety and soundness examination that FDIC participated in; however, compliance with the policy guidelines was not strictly enforced. In effect, OTS allowed management to delay and under-report adverse loan classifications and to overstate loan portfolio and capital values.

Based on the FDIC's January 24, 2000 memorandum to the file, regarding the OTS safety and soundness examination, substantially all automobile loans originated were considered subprime and were originated with the intent of securitizing and selling them in the secondary market. From the inception of the automobile loan program in 1994 to December 1999, the bank originated approximately \$884 million in automobile loans with an average interest rate of 17.7 percent. At the height of operations, from April 1998 through September 1999, Superior originated approximately \$493 million in automobile loans, which represented 56 percent of the total dollar volume of all automobile loans originated. As of December 31, 1999, automobile loans reported on the bank's balance sheet totaled \$274 million and equaled 29 percent of total loans outstanding of \$934 million.

Superior retained significant off-balance sheet risk from automobile loan securitization activities due to the existence of loan recourse arrangements. Prior to 1999, automobile loans were securitized and sold under a recourse arrangement in which Superior was required to repurchase nonperforming loans. In 1999, automobile loans were securitized and sold with an allowance for loan losses equating to approximately a 15 percent loss-rate factor; however, if that cushion became depleted Superior would still be required to fund credit losses. Loans on the bank's books included newly originated loans held for sale, loans originated for sale that became delinquent before a sale could be consummated, and nonperforming loans which the thrift was obligated to repurchase under the recourse agreements. Based on an interview, the OTS Field Manager speculated that the losses incurred by the bank in the automobile portfolio might have contributed to management's decision to lower credit underwriting standards in the mortgage portfolio and to increase the valuations of the residual interest accounts. If true, these actions would have resulted in a short-term increase to earnings and capital, while increasing the long-term risk to the institution. Table 15 shows the amount of automobile loans outstanding and charged-off in relationship to total loans outstanding and charged-off from 1994 to 2001.

⁶⁷ Due to a subsequent modification, the effective date for fully implementing the Uniform Policy was extended to December 31, 2000. On June 12, 2000 the Uniform Policy was revised to clarify various items within the policy with respect to (1) the re-aging of open-end accounts; (2) extensions, deferrals, renewals, and rewrites of closed-end loans; (3) examination considerations; and (4) the treatment of specific categories of retail loans.

Table 15: Automobile Loans and Related Losses

Calendar Year	Total Loans (000's)	Total Loans Charged-Off (000's)	Total Auto Loans (000's)	Total Auto Loans Charged-Off (000's)	Total Auto Loans as a Percent of Total Loans	Total Auto Loans Charged-Off as a Percent of Total Loans Charged-Off
	A	B	C	D	C/A = E	D/B = F
1994	\$ 507,998	\$ 894	\$ 6,225	\$ 0	1%	0%
1995	504,632	1,418	68,813	0	14%	0%
1996	402,344	6,773	17,761	2,420	4%	36%
1997	466,917	17,584	28,830	6,805	6%	39%
1998	648,496	30,907	225,016	777	35%	3%
1999	934,036	45,525	273,970	21,658	29%	48%
2000	588,503	*154,927	65,488	6,157	11%	*44%
2001**	416,994	29,410	2,386	27,878	1%	95%

Source: OIG Analysis of Thrift Financial Reports and OTS's Reports of Examination

*This number includes the charge-off of other assets totaling \$141 million. This amount was reflected in the column Total Loans Charged-Off, but was excluded from the ratio calculation of Total Automobile Loans Charged-Off to Total Loans Charged-Off. This number is attributed, in part, to the \$125.9 million reduction that was required at the conclusion of the 2000 examination. This reduction was required to exclude unsubstantiated funds that were in the allowance for loan and lease losses.

**This period is for the six months ended June 30, 2001.

In assessing the automobile loan portfolio,⁶⁸ OTS supervisory personnel consistently identified the level and trend of loan underwriting and asset securitization activities. In the October 27, 1997 ROE, OTS examiners first identified that management failed to classify delinquent automobile loans and repossessions in regulatory/supervisory reports. The examiners noted that automobile loans delinquent 90 to 119 days and repossessed automobiles were not classified. Then again in the January 25, 1999 ROE, OTS examiners noted management's failure to classify certain automobile loan accounts. These accounts dealt with balances involving:

- deficiency amounts due after collateral liquidation entitled "Liquidated Deficiency" (\$13.6 million),
- delinquent borrowers who were hiding their automobile from repossession entitled "Note Suits" (\$9.3 million),
- loans held for sale that were past due at least 3 months (\$.5 million), and

⁶⁸ In accordance with the Report of Examination instructions, "Asset quality is evaluated in relation to the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on- and off-balance sheet; the adequacy of the allowance for loan and lease losses and other valuation reserves; demonstrated ability to identify, administer and collect problem assets; the diversification and quality of loan and investment portfolios; the adequacy of loan and investment policies, procedures, and practices; extent of securities underwriting activities and exposure to counterparties in trading activities; credit risk arising from or reduced by off-balance sheet transactions; asset concentrations; volume and nature of documentation exceptions; effectiveness of credit administration procedures, underwriting standards, risk identification practices, controls, and management information systems."

- deficiency amounts due after insurance proceeds (\$.3 million).

As presented within the ROE, these account balances totaled \$23.8 million, and were comprised of amounts that were inappropriately classified by management. Excluding the loans held for sale, all of the above balances should have been charged-off in accordance with interagency policy guidelines; however, OTS allowed approximately \$10.7 million to remain on the bank's books. No reference was made to the 1980 Policy or to the Uniform Policy.

OTS first utilized the Uniform Policy during the January 24, 2000 examination in which the FDIC participated. However, OTS's interpretation and guidance were liberal and did not thoroughly reflect Uniform Policy guidelines. In particular, OTS stipulated that the Uniform Policy allowed institutions to avoid a 100 percent charge-off by determining the fair value less selling cost of the collateral and charging off the book balance for any amounts in excess. Management was also informed that the Uniform Policy stipulated that valid insurance claims could be used to support an asset. Based on these two positions, approximately \$22 million was not charged-off by OTS. Alternatively, OTS requested that management perform a review and make any necessary corrections. Before performing a review, management had stated to OTS that the loans in question were adequately protected by the loans' collateral values, and any resulting charge-off would be unlikely. OTS also recommended that the bank amend its policies to reflect a charge-off to retail closed end credit upon 120-day delinquency, unless the loan is well secured.⁶⁹ The guidance provided by the OTS did not coincide with the definition of "well secured and in the process of collection," and the presence of specific allowances on these accounts cast doubt about management's ability to reasonably collect on these loans regardless of delinquency status.

OTS's interpretation and guidance also did not thoroughly reflect the guidance provided in the Revised Policy. While not issued until June 12, 2000 and not presented by the OTS, the Revised Policy provided further clarification on classifying loans that become severely delinquent.⁷⁰ While this guidance would have allowed management to avoid a 100 percent charge-off on automobile loans that were 120 days past due, OTS did not assess the bank's process of establishing the value of the collateral. In addition, OTS did not provide guidance of when repossession of the collateral is "assured and in process." The Revised Policy also provided specific guidance for customer accounts in bankruptcy status. Accounts in bankruptcy should be charged-off within 60 days of receipt of

⁶⁹ The Uniform Policy stipulates, "If an institution can clearly document that the delinquent loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities, with an estimated fair value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. In the process of collection means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days."

⁷⁰ The Revised Policy stipulates, "Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified Loss and charged-off. In lieu of charging off the entire loan balance, loans with non-real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process."

notification of filing from the bankruptcy court or within the 120-day time period specified within the policy statement, whichever is shorter, unless the institution can clearly demonstrate and document that repayment on accounts in bankruptcy is likely to occur. OTS did not request and/or management did not provide this documentation.

In the March 19, 2001 ROE, examiners reported that management tracked the actual loss experience for each type of segregated asset group in order to determine estimated losses. These loss experience ratios were then utilized as the basis for a partial charge-off of all dollar amounts in the 120 days delinquent category. The methodology used by management and allowed by OTS conflicts with the guidance presented in the prior ROE and with the Uniform and Revised Policies.

The following table summarizes the amounts questioned and charged-off by OTS for the last three safety and soundness examinations conducted. The amounts not charged-off and not reviewed in accordance with interagency guidelines, represents the additional loss not recognized by the bank that could have potentially been charged-off if the interagency policy had been strictly adhered to and enforced.

Table 16: Automobile Balances Reviewed by OTS

Financial Statement Date	Questioned Auto Loan/Asset Amounts (000's)	Amounts Charged-Off (000's)	Amounts Not Charged-Off and Not Reviewed in Accordance with Interagency Guidelines (000's)
03/31/01	\$ 9,697	\$ 0	\$ *9,697
12/31/99	73,739	**47,400	***21,992
12/31/98	23,790	12,498	11,292

Source: OIG Analysis of OTS Reports of Examination

* This amount consisted of loans in bankruptcy status, pending insurance claims, and repossessed automobiles.

** Of the \$47.4 million, \$31.8 million was derived from two accounts discussed in the previous year, which OTS did not require the bank to fully charge-off. These accounts were entitled Liquidated Deficiencies and Note Suits and were recognized as the most severely impaired accounts.

*** This amount represents the balance of four loan categories that were 120 days past due. The four loan categories were entitled Bankruptcy, Insurance Claims, Assigned for Repossession, and Repossessed Automobiles. Specific allowances for loan losses were outstanding on these accounts and totaled \$4.3 million. The specific allowance equaled 17 percent on the outstanding loan balance not charged-off of \$26.3 million.

Examination guidance implementing the interagency policy was provided within the OTS Regulatory Handbook. Based on interviews, the Examiner-in-Charge of the October 7, 1996 examination stated that the bank had just begun operations in the automotive lending area and the amounts were not material enough to perform a detailed review. The examiner-in-charge of the January 25, 1999 examination noted that the bank was not using the Uniform Policy to classify automobile loans; instead, Superior was using a historical loss experience method. The OTS examiner stated that he chose not to follow the policy guidance and that Superior's process seemed adequate. The examiner also stated that he felt he would just report the bank's review process and let the regional office decide what to do. The lead FDIC examiner, of the January 24, 2000 examination,

stated that the OTS examiners were unfamiliar with the policy and with its requirements. The OTS examiner-in-charge of the January 24, 2000 examination, stated that the bank was still using a historical analysis method to classify the automobile loans, and the bank should have complied with the interagency policies; however, the FDIC and the OTS did not agree with what the policy required. Based on discussions with OTS's senior management, they indicated that the OTS fully supports and intended to comply with all interagency policies. OTS senior management also did not know why the interagency policies were not followed.

The total loss experienced by the bank due to automobile lending and securitization activities was significant. Based on the amount of loss reported within the bank's TFRs total losses recorded from the automobile loan portfolio equaled approximately \$66 million. This balance does not include the cost of terminating the automobile loan operations. In addition, when examination review procedures are implemented during the initial phases and offerings of new programs and products, areas of potential concern can be identified and measures can be recommended to limit and/or mitigate risk to an institution. The delay in implementing the interagency policies resulted in OTS becoming reactive to mounting loan underwriting and classification problems, and allowed management to delay and under-report adverse loan classifications and to overstate loan portfolio and capital values.

New Bank Activities

As noted in the preceding section, Superior began the automobile loan program in 1994. However, a comprehensive review of the bank's policies, procedures, and projections was not performed when the automobile loans were first offered. In particular, changes in operations, which include offering new loan products, can pose significant risk to an institution. Regardless of the level of current activity, consideration has to be given to the significance of the projected level of operations and resource allocation. Furthermore, the ROEs did not mention management's plans to initiate automobile loan activities within discussions of the bank's budget and strategic plans. While OTS identified the level and trend of loan underwriting and asset securitization activities, in-depth reviews were only performed after the loan balances represented a material portion of assets. As a result, target ratios, parameters, and controls used to limit/mitigate risk could have been recommended by OTS and implemented by management, but were not.

The OTS Regulatory Handbook states that scoping an examination requires a special emphasis on risk analysis and prioritization. The depth of review varies in each area according to the institution's size, activities, and condition. Examiners are expected to perform less of a review in those areas where no significant present or potential risk exists and to perform more of a review where major risk is present or possible. Examiners are also reminded that major areas of risk do not necessarily mean problems; some risk is part of operating any profitable institution. Examiners are to include procedures that enable them to determine if the institution's level and management of risk are unsafe and unsound. They are also instructed to concentrate on changes in operations or management because these can pose significant risk. The OTS Handbook also

requires a review of policies and procedures when assessing an institution's consumer lending portfolio, and specific reference is made to reviewing an institution's compliance/adherence to the Uniform Policy.

While the OTS Regulatory Handbook instructs examiners in how to risk focus and scope an examination, Superior's automobile lending area was not identified as an emerging risk. The Examiners-in-Charge of the 1994, 1995, and 1996 examinations stated that a comprehensive review of the automobile lending area was not performed because the activity was not material. The Examiner-in-Charge of the 1996 examination also stated that he believed that management's plans to enter the automobile lending area were not sound and that management lacked the necessary expertise. However, despite this view, he stated that an examiner can only deal with what exists at the time and that restrictions or capital requirements cannot be imposed until you start having losses.

The effect of not performing a comprehensive review on a new and emerging area of activity was a delay in the assessment and oversight of this activity. Furthermore, the scale of the bank's planned activity was not fully considered in assessing risk or in evaluating the safety and soundness of the institution. As a result, potential weaknesses in operations and management expertise were not identified, and target ratios, parameters, and controls used to limit/mitigate risk were not recommended or implemented. Similar to the previous section concerning the bank's adherence to interagency policies and procedures, the delay in following and implementing OTS's regulatory examination guidelines resulted in OTS becoming reactive versus proactive to mounting loan underwriting and classification problems.

Federal Deposit Insurance Corporation

From 1993 through 1999, the FDIC did not materially⁷¹ participate in the onsite examination process of Superior. However, the FDIC did participate in the last two safety and soundness examinations that were conducted. The FDIC's onsite examination participation during the January 24, 2000 and March 19, 2001 safety and soundness examinations identified weaknesses and problems within the institution. During the 2000 examination, the FDIC had a limited focus that centered primarily on the following areas: residual interests and securitization activities, valuation reserves and capital, audit and independent review programs, asset quality, and management. The activities reviewed by the FDIC during the 2001 examination were centered on servicing operations, securitization program, and retail bank/accounting department operations. During these examinations, the FDIC helped to identify weaknesses involving the Board of Directors' oversight of the institution, automobile and mortgage securitization activities, and valuation of residual interests and the OC accounts.

The FDIC's offsite monitoring of Superior was effective in detecting potential areas of concern with the institution in 1998 and 1999; however, earlier OTS ROEs exhibited weaknesses that the FDIC did not address. Specifically, in September 1998 the FDIC recognized that Superior exhibited a high-risk asset structure, possessed significant

⁷¹ FDIC participated in a concurrent visitation, dated July 3, 1993.

investment concentrations in residual interest securities and high coupon loans held-for-sale, had a high past due loan ratio, and had increasing levels of repossessed assets. In addition, the FDIC noted that Superior had substantial recourse exposure in loans “sold” through its securitization program, and the FDIC identified that discrepancies existed between TFR data and audited financial statements concerning the allowance for loan and lease losses. Furthermore, the FDIC noted that the operating characteristics of the institution were uncommon in the region and were deserving of further investigation. While the high past due loan ratio was an emerging issue in 1998, the other particular concerns were evident in previous years and were not questioned by the FDIC. In addition, the FDIC did not recognize the inherent risk that existed in the over-reliance on imputed gains to support earnings and to justify the payment of dividends; the FDIC did not recognize that while capital ratios exceeded regulatory minimums for the definition of “well capitalized” more capital was needed; and the FDIC did not question OTS’s lack of follow up on previous examination recommendations.

Other high-risk indicators that were discussed previously would have been difficult for the FDIC, as the back-up regulator, to ascertain through offsite monitoring. These other indicators include such as items as:

- noncompliance with statutory rules and regulations,
- supervisory over-reliance on management and the external auditors in establishing, supporting, and verifying the appropriate valuations of the residual interests and OC accounts,
- noncompliance with GAAP,
- the lack of adoption and adherence to interagency policies and procedures, and
- the lack of review of new bank activities.

The cause of the FDIC’s delay in initially detecting potential areas of concern through the offsite monitoring process is uncertain. However, when the FDIC did begin to detect potential problems in 1998, a new Case Manager and Assistant Regional Director had been assigned oversight responsibility for Superior. The Case Manager was recognized as possessing expertise in the areas of accounting and capital markets.

An earlier response by the FDIC could have potentially slowed the growth of the institution and limited the exposure to its high-risk activities. As a result, losses could have been limited and the bank’s failure possibly prevented. Conversely, losses could have been greater if the FDIC had not initially identified its supervisory concerns and requested to participate in subsequent OTS examinations.

Topic 6 - The effectiveness of the supervisory actions taken by the regulators in addressing the problems identified during their onsite examinations and offsite monitoring process.

Owing to the presence of limited regulatory criticism identified during the 1990s, the Office of Thrift Supervision took no regulatory supervisory actions against Superior until July 2000. By the time this action was taken, the continued viability of the institution was dependent upon a capital injection. The FDIC helped to identify weaknesses and problems within the institution during its onsite examinations and offsite monitoring processes. However, regulatory authority limited the FDIC's actions and effectiveness.

Regulatory Supervisory Actions

OTS undertook limited regulatory supervisory actions. The first regulatory supervisory action taken was the issuance of a directive under 12 CFR Part 570 in July 2000. This directive stipulated that the bank was to develop a safety and soundness corrective program that addressed, in part, residual interests valuations, residual assets⁷² concentrations, internal controls, credit underwriting, allowance for loan and lease losses policies and procedures, and asset quality. In October 2000, OTS conducted a bank visitation that reviewed management's compliance with the directive and with other recommendations made from the January 2000 examination. No other regulatory corrective actions were issued until February 2001, when OTS issued a PCA directive to Superior and a cease and desist order against the bank's first and second tier holding companies. While the bank submitted a capital restoration plan in accordance with the PCA notice in March 2001, the plan was deemed unacceptable. After three amendments and two revisions, the OTS accepted and approved the capital restoration plan in May 2001. However, in July 2001, owners of the bank notified the OTS that the Capital Plan would not work, and OTS closed the bank and named the FDIC as receiver.

OTS's Application of the Provisions of Prompt Corrective Action

Section 38 of the FDI Act, Prompt Corrective Action 12 USC §1831(o), was created to resolve the problems of insured depository institutions to achieve the least possible long-term loss to the deposit insurance funds. It also requires each federal banking authority to establish minimum capital levels to assist in the regulation and implementation of this section. Section 38 stratifies institutions into five different capital categories. These categories range from the highest group referred to as "well capitalized" to the lowest

⁷² The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

sector known as “critically undercapitalized,” with three intermediate stages. As the capital categories descend from well capitalized to the lower levels, the law applies more restrictions to institution activities, and the federal banking agencies are required to take increasingly severe actions to attempt to halt the deterioration in the institution. These actions range from restricting certain activities, such as asset growth and dividend payments, to closing institutions that remain in a critically undercapitalized state.

Because of the lack of accurate information from 1993 until the end of 1999, it is impossible to determine if the OTS applied the provisions of PCA correctly to Superior. This is due to the misapplication of FAS 125 to the OC account beginning in 1995, the adoption of a more liberal discount assumption in 1999 (refer to Topics 2 and 4 for additional information), the misapplication of interagency classifications (refer to Topic 5 for additional information) and the excessive dividend payments based on gain on sale accounting beginning in 1993 (refer to topic 7 for additional information.) If these areas had been detected and corrected earlier, perhaps the capital ratios reflected in the OTS reports would have more validity. However, based on the OTS examination reports and the actual events that transpired at the institution, an accurate assessment of OTS’s application of PCA cannot be determined for these years. However, beginning with the 2000 examination, we believe that the OTS did not apply the provisions of PCA appropriately.

At the conclusion of the January 2000 examination, the risk-based capital ratios on a pre- and post-tax basis were 7.81 and 8.57 percent. By using the post-tax capital ratio, Superior was classified as “adequately capitalized.” If the OTS had elected to use the pre-tax capital ratios, Superior would have been “undercapitalized.”

Superior’s composite rating was nonetheless downgraded from a “2” to a composite “4,” reflecting the sharp decline in the overall condition of the institution due primarily to the high-risk lending program and the inordinate concentration in residual interests and the unsupported assumptions used to value them.

According to the OTS legal counsel, the institution could have been reclassified under PCA provisions and treated as if it were in the next lower capital category, which would have been “undercapitalized” thus subjecting the institution to various constraints under PCA. Because of its deteriorating condition due to the excessive volume of concentrations in high-risk assets, the OTS would have had the leverage to implement corrective measures earlier. However, the OTS did not take any actions under the guidelines of PCA at that time.

The OTS and the FDIC conducted a visitation at Superior in October 2000. Although the emphasis of the visitation was not focused on the institution’s PCA category, a schedule included at the end of the OTS visitation report indicates the capital levels at the conclusion of the visitation. After performing the calculations of the pre- and post-tax columns, the results reveal that Superior was “significantly undercapitalized.” On a pre-tax basis, the risk-based capital ratio was 2.33 percent; on a post-tax basis, the risk-based capital ratio was 5.20 percent.

On February 14, 2001, the OTS issued a PCA Directive to Superior. This action was based on activities that occurred at the January 2000 examination and activities that were discovered at the October 2000 visitation, which were not resolved until January 2001. The resulting write-down in the OC account (refer to Topic 2 for additional details) of \$270 million caused Superior to fall into the significantly undercapitalized PCA category as of December 31, 2000. During the March 2001 examination, the OTS did not require the write-down of the residual interests for an additional \$150 million due to the overvaluation resulting from the use of liberal discount assumptions. The OTS did not require the write-down at this time because of the negotiations between Superior's owners and the regulators associated with a recapitalization plan.

The OTS is responsible for implementing and enforcing PCA regulations for the institutions that it supervises. The FDIC becomes involved only when an institution is considered critically undercapitalized, which is when the tangible equity capital ratio is equal to or less than 2 percent. Superior's tangible equity capital ratio hovered above the 2 percent threshold thereby precluding the FDIC from becoming involved since the institution was not yet considered critically undercapitalized.

By calculating the tax effect on loss classifications before calculating the capital ratios, the ratios can be inflated for PCA purposes. This is due to the reduced level of loss that is deducted from capital. For example, if losses total \$10 million and a 39 percent tax rate is used, the resulting deduction from capital would be \$6.1 million instead of the entire \$10 million ($\$10,000,000 \times .39 = \$3,900,000$. $\$10,000,000 - \$3,900,000 = \$6,100,000$). By deducting the smaller \$6.1 million value, the capital remains at a higher level, thereby increasing the resulting capital ratios. However, if the institution does not have sufficient income to realize a benefit from the tax effect, we believe that the calculation misrepresents the capital position. In fact, Superior was not making money and had no real income against which to offset the losses. Accordingly the "post-tax" rate was invalid and should not have been used. There was no evidence that the FDIC objected or approved of the post-tax calculation.

The OTS has not issued any specific guidelines stating whether the calculation of the pre- and post-tax capital ratios are a permissible activity or outlining particular circumstances when examiners may use discretion and recalculate the ratios by incorporating a tax effect for loss classifications. The Managing Director of Supervision of the OTS responded to an OIG request for information on this issue in a December 21, 2001 letter that stated that "applicable OTS law, regulations, policies, and financial reporting guidance clearly state that the agency follows generally accepted accounting principles (GAAP)," and that GAAP required "determining the impact of income taxes on regulatory capital." However, the Director did not indicate what process is used to determine if an institution can or will actually derive a benefit from the resulting tax effects. When the OTS was calculating the year-end 2000 capital ratios, a memo in the file from the OTS Chicago regional accountant indicated that since it was questionable whether or not Superior could realize the tax benefit immediately, a better indication of the capital ratios was reflected using the pre-tax ratios.

The OTS incorporated an effective tax rate of 39 percent on the loss classifications resulting in higher capital ratios and a higher PCA classification for Superior. When we confirmed how the OTS would calculate a tax rate in these circumstances, the OTS Chief Accountant stated that the application of an effective tax rate would not result in an accurate tax estimation for Superior due to its extremely complex structure. Since the capital ratios were higher by adjusting the capital deductions by applying a tax effect to the losses, Superior did not technically reach the critically undercapitalized category until July 24, 2001 when all loss classifications from the 2001 examination were deducted from capital as a result of the owners' refusal to implement the capital restoration plan. Based on Superior's insolvency, the institution was placed into receivership on July 27, 2001.

Office of Thrift Supervision Actions Impede Regulatory Process

Three of OTS's actions appear to have impeded the regulatory process. In particular, OTS did not always follow up on prior examination recommendations, did not allow FDIC's onsite participation in the January 25, 1999 safety and soundness examination, and calculated regulatory capital ratios on an after-tax basis. (Refer to Topics 5 and 9 for additional information.) Individually and collectively these actions served to limit effective actions from being implemented. In the July 6, 1993 ROE, OTS recommended that the bank develop a comprehensive dividend policy that considered the impact on capital from those assets (gains) created from the securitization and sale of loans. Had this recommendation been implemented by Superior and followed up on by OTS, Superior, potentially, would not have declared any dividends and would have had over \$200 million more in capital. However, this recommendation was never repeated in subsequent reports. In addition, in the August 8, 1994, and September 11, 1995, ROEs, OTS criticized management for errors in Superior's capital calculations. However, corrective action was not implemented by the institution, nor did OTS formally follow up and reiterate these criticisms and recommendations in subsequent examination reports. The OTS re-identified and presented the errors again in the January 24, 2000 examination, along with further criticisms about management's ability to substantiate the allowance for loan and lease losses. While the lack of follow up on prior examinations appears to have been an oversight, the limits placed on the FDIC's participation in the examination process and the calculation of regulatory capital ratios using after-tax effects were intentional decisions by OTS.

Federal Deposit Insurance Corporation

The FDIC helped to identify weaknesses and problems within the institution during its onsite examinations and offsite monitoring processes. However, the FDIC's lack of direct regulatory authority limited the FDIC's actions. In particular, the FDIC first identified the bank's high-risk asset structure and increased its supervisory concern in September 1998. In December 1998, the FDIC formally requested to participate in OTS's 1999 safety and soundness examination. When OTS limited the FDIC participation in the 1999 onsite examination, the FDIC's Chicago Regional Office did not pursue the use of its special examination authority by presenting a board case to the

FDIC's Board of Directors to request access to the institution. Regardless, based on the results of the January 25, 1999 safety and soundness examination, the FDIC perceived a greater degree of risk than OTS and downgraded the bank's rating for risk related premium purposes. Subsequently, the FDIC participated in the last two examinations and provided review and consultative guidance to OTS. While the FDIC enhanced the supervisory review process, the FDIC did not identify and formally express concern over OTS's methodology of calculating the bank's regulatory capital ratios on an after-tax basis. As a result, the implementation of PCA was delayed.

Topic 7 - The regulators' monitoring of transactions between Superior and its holding company and affiliates, including the up-streaming of dividends.

The Office of Thrift Supervision (OTS) did not adequately monitor transactions between Superior and its holding companies and affiliates, even though OTS regulated both Superior and its holding companies. Consequently, transactions prohibited by the Federal Reserve Act were allowed to continue for more than 2 years, resulting in a \$36.7 million loss to Superior as assets and cash were improperly transferred to Superior's affiliates and holding company. In addition, Superior's dividend payments had a detrimental effect on capital. Based on Superior's policy of limiting dividends to 50 percent of net income, Superior distributed more than \$200 million in dividends to its holding company, \$12.5 million of which was not reported on Superior's Thrift Financial Reports. OTS assessed the reasonableness of dividends based on the bank's recorded amount of net income; however, the OTS's analysis was flawed. In particular, a significant portion of the bank's net income was made up of imputed gains, which were unrealized and subject to significant market and economic volatility. OTS did not assess the reasonableness of dividends based on gains that were actually realized by the bank on a cash flow basis.

Monitoring Transactions

In regulating both Superior and its holding companies – Coast-To-Coast Financial Corporation (CCFC) and Superior Holdings, Inc. (SHI) – the Office of Thrift Supervision (OTS) was in a unique position to review transactions between them from two different perspectives. In fact, OTS Reports of Examination (ROE) for both the thrift and its holding companies discussed the review of transactions with affiliates and the payment of dividends. However, OTS performed four exams of Superior and its holding companies without discovering \$36.7 million in transactions that were prohibited by the Federal Reserve Act.

Thrift Reports of Examination

Section 380 of OTS's Thrift Activities Regulatory Handbook, entitled "Transactions with Affiliates and Insiders," prescribes detailed and thorough procedures for OTS examiners. In fact, OTS reviewed transactions with affiliates and the payment of dividends as part of each full-scope examination performed for Superior. However, no criticism of transactions was noted until the March 2001 exam. That was Superior's last exam and was completed in July 2001 but not finalized before Superior was closed. In that report, OTS stated that Superior was in apparent violation of several regulations regarding transactions with affiliates and the transactions had been ongoing since April 1999. In total Superior was owed more than \$36.7 million by CCFC and its affiliates as of March 31, 2001, as detailed in the following table.

Table 17: Superior’s Unsecured Extensions of Credit to Affiliates

Company and Purpose of Credit from Superior	Amount (in thousands)
Coast-To-Coast Financial Corporation (CCFC)	
Market premium on Series 2000-3 securitization	\$ 7,363
Market premium on Series 2000-4 securitization	10,796
Additional premium on 2000-4 for subsequent transfer	2,099
Premium on Sold Loans	\$ 20,258
Accrued interest on Series 2000-3 securitization	3,010
Accrued interest on Series 2000-4 securitization	2,980
Accrued Interest on Sold Loans	\$ 5,990
Interest paid to Merrill Lynch on securitization funding line	5,230
Total Advances to CCFC	\$ 31,478
Alliance Funding Company of Nevada (AFCN)	
Non-recoverable servicer advances	\$ 4,945
Coast-To-Coast Auto Dealer Corporation (CCADC)	(656)
Coast-To-Coast Leasing Corporation (CCLC)	
Marketing fees	936
Total Unsecured Extensions of Credit to Affiliates	\$ 36,703

Source: Office of Thrift Supervision and Federal Deposit Insurance Corporation Reports of Examination.

The earliest of these transactions related to six REMICs⁷³ that had all been called and closed. Superior had made more than \$4.9 million in advances on loans recognized as charge-offs. The advances were made on behalf of Alliance Funding Corporation of Nevada, Inc. (AFCN), a Superior affiliate that owned the residual interest of the REMIC trusts benefiting from the advances. As of April 30, 1999, AFCN had sold the underlying loans. However, Superior, as servicer, failed to collect the advances due from the trust. The resulting loss should have been absorbed by AFCN, and not Superior.

As of March 31, 2001, Superior transferred \$4.9 million from nonrecoverable advances on the servicing division’s books to accounts receivable on the corporate division’s books. OTS reported that this transaction was considered an affiliate violation of 12 CFR §563.42. This rule requires that transactions with affiliates be on terms and under circumstances that are substantially the same, or at least as favorable to the savings association, as those prevailing at the time for comparable transactions with non-affiliated companies. The holding company subsequently agreed to reimburse Superior for the \$4.9 million after the Capital Plan was implemented, and to pay interest on the unpaid balance. The Capital Plan was never implemented and reimbursement was not made.

An additional \$31.4 million of the receivable related to loan sale activity in the second half of 2000. At that time Superior was incurring operating losses and had a composite CAMELS rating of “4.” According to OTS’s January 2000 ROE, Superior was only adequately capitalized at that time, and its capital level was insufficient for Superior’s

⁷³ Real Estate Mortgage Investment Conduit (REMIC) is a multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans and is explained further in the Glossary.

primary business activity as a nationwide subprime mortgage banker with residual assets and loan servicing assets that were approximately twice its tangible capital. Further, on July 7, 2000, OTS notified Superior that pursuant to issuance of the January 24, 2000 ROE it was a problem association⁷⁴ as defined in Regulatory Bulletin 27a, and was in troubled condition⁷⁵ as defined under 12 CFR §563.555. As such, Superior was immediately subject to several restrictions on asset growth, compensation and other employment considerations. As a further result of the January 2000 examination, OTS also required a corrective program that included restricting any additional residual interest assets⁷⁶ from being added to Superior's balance sheet.

In compliance with the corrective plan, Superior stopped securitizing loans on June 30, 2000. Even so, Superior continued to originate subprime loans. Instead of securitizing the loans and retaining the residual assets, Superior sold the loans it originated to its holding company. CCFC then securitized the loans and retained the residual assets.

However, during the third and fourth quarters of 2000 Superior sold loans to CCFC at less than fair market value. CCFC quickly resold the loans at a higher price, resulting in more than \$20.2 million in gains to CCFC. According to OTS, it appeared that CCFC benefited from terms and conditions that were not at arm's length and were to the detriment of Superior. Further, OTS concluded that Superior's sale of the loans to CCFC constituted a sale of assets to an affiliate at a price of less than fair market value.

According to OTS, this was an apparent violation of 12 CFR §563.42. This Section requires that transactions with affiliates be on terms and under circumstances that are substantially the same, or at least as favorable to the association, as those prevailing at the time for comparable transactions with non-affiliated companies. When CCFC recognized it had not properly accounted for the fair market value of the loans, it caused Superior to book a receivable of approximately \$20.2 million. The receivable represented an extension of credit to CCFC from Superior. According to OTS, this extension of credit

⁷⁴ In general, OTS Regulatory Bulletin 27a (RB 27a) defines a problem association as a savings association that: (1) has a composite rating of 4 or 5; (2) is undercapitalized under prompt corrective action standards; (3) is subject to a capital directive, cease and desist order, consent order, or formal written agreement relating to the safety and soundness or financial viability of the savings association; or (4) has been notified in writing by the OTS that it has been designated a problem association or an association in troubled condition.

⁷⁵ Under 12 CFR §563.555, troubled condition, in general, means: (1) a savings association that has a composite rating of 4 or 5; (2) a savings and loan holding company that has an unsatisfactory rating under OTS's holding company rating system, or that is informed in writing by the OTS that it has an adverse effect on its subsidiary savings association; (3) a savings association or savings and loan holding company that is subject to a capital directive, cease-and-desist order, consent order, formal written agreement, or prompt corrective action directive relating to the safety and soundness or financial viability of the savings association; or (4) a savings association or savings and loan holding company that is informed in writing by the OTS that it is in troubled condition based on information available to the OTS.

⁷⁶ The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

was an apparent violation of 12 CFR §563.41(c), which requires that extensions of credit to affiliates be collateralized. The transaction was also an apparent violation of 12 CFR §563.41(e), which requires savings associations to maintain adequate documentation of their transactions with affiliates.

The \$36.7 million receivable also included approximately \$5.2 million, incurred when CCFC obtained a warehouse funding line of credit from Merrill Lynch & Co. as part of the same loan sale. When that line was repaid, Merrill Lynch assessed CCFC approximately \$5.2 million to cover additional interest expense on the funding line. Superior, on behalf of CCFC, advanced the \$5.2 million.

Superior also booked as part of the receivable approximately \$5.99 million to reflect an amount in accrued interest on the loans that were sold to CCFC that was owed to Superior as part of the loan sale. Lastly, the receivable included approximately \$936,000 in marketing fees that were owed to Superior from CCFC.

In each of these transactions, Superior extended credit to its affiliates. According to OTS, these extensions of credit were in apparent violation of 12 CFR §563.41(c), which requires the collateralization of extensions of credit to an affiliate. The transactions also appeared to violate 12 CFR §563.41(e), which requires adequate documentation of transactions with affiliates. Moreover, it appears that these transactions also violated 12 CFR §563.42. This Section requires that transactions with affiliates be on terms and under circumstances that are substantially the same, or at least as favorable to the association, as those prevailing at the time for comparable transactions with non-affiliated companies.

Originally, the payment by CCFC of the receivable was to be accomplished through a transfer of the value of future cash flows from certain mortgage and auto loan residual interests owned by CCFC. These cash flows were valued at approximately \$92.7 million by CCFC. OTS estimated that the present value of these assets was \$81.0 million when they were transferred March 30, 2001. The portion of the cash flows not used to repay the referenced receivable was to be used as a contribution of capital to Superior.

According to OTS, the transfer of cash flows to repay the receivable owed to Superior from CCFC constituted a purchase of assets under the transactions with affiliates regulations and the fair market value of the cash flows was never adequately established. In addition, Merrill Lynch & Co. encumbered a large portion of the cash flows. OTS stated that this transaction was not adequately documented and was not on terms and under circumstances that are substantially the same, or at least as favorable to the association, as those prevailing at the time for comparable transactions with non-affiliated companies. Therefore, OTS concluded that the repayment transaction itself was an apparent violation of 12 CFR §563.41(e) and 12 CFR §563.42.

In April 2001 the OTS was notified that payment of the referenced receivable was being reversed and that the full amount of the value of the cash flows was being included as a capital infusion to Superior. This reversal was confirmed through OTS's review of

Superior's March 31, 2001 TFR that was filed on April 30, 2001. According to OTS, this resulted in Superior booking a receivable from CCFC totaling \$36.7 million, which created the same transaction with affiliates violations noted before the transfer of the cash flows. Namely, it was a violation of 12 CFR §563.41(c), 12 CFR §563.41(e), and 12 CFR §563.42.

Furthermore, OTS noted that these extensions of credit and asset purchases also appeared to violate 12 CFR §563.41(a)(1)(i) and §563(a)(1)(ii). These Sections prohibit the aggregate amount of covered transactions with any affiliate from exceeding 10 percent of the capital and surplus of the savings association, and prohibit the aggregate amount of covered transactions with all affiliates from exceeding 20 percent of the capital and surplus of the savings association.

Between April 1999 when the prohibited transactions began and the March 2001 exam when the transactions were reported, OTS performed full-scope examinations of Superior, CCFC, and SHI in January 2000 and a visitation for Superior in October 2000. In our opinion, all four reviews should have disclosed the prohibited transactions. The OTS management official in charge of the examinations also stated that OTS examiners should have found the prohibited transactions during these exams.

The FDIC also participated in the January 2000, October 2000, and March 2001 reviews of Superior. However, according to the FDIC planning documents, the FDIC examiners focused on Capital, Assets, and Management – specifically, securitization activities, high-risk loan portfolio, and complex regulatory accounting and reporting issues. FDIC personnel stated they did not review transactions between Superior and its holding companies and affiliates, or payment of dividends.

Holding Company Reports of Examination

OTS also reviewed transactions with affiliates and dividend payments in every examination of Superior's holding companies, CCFC and SHI. OTS consistently gave the holding companies "Satisfactory" ratings, except in its May 2001 reports. However, the May 2001 reports were not finalized until after OTS closed Superior, and the reports were not forwarded to the holding companies. The apparent violations of Sections 23A and 23B of the Federal Reserve Act were not reported in the January 2000 holding company ROEs. Nonetheless, according to the OTS management official in charge of the examinations, the violations should have been found.

In the May 2001 reports, OTS gave the holding companies "Unsatisfactory" ratings because of the poor financial condition of the thrift. The apparent violations of law were mentioned in CCFC's report but not explained, and OTS simply noted that recovery of the funds was addressed in the Capital Plan. However, the Capital Plan was never completed, and the \$36.7 million was not repaid before Superior failed.

Notwithstanding its Satisfactory ratings in earlier reports, OTS criticized CCFC in almost every holding company examination report for late filings of required regulatory reports;

specifically, quarterly and annual H-(b)11 reports. Section 10(b)(2) of the Home Owners' Loan Act (HOLA), as amended, 12 U.S.C. §1467a(b)(2), and 12 CFR §584.1(a)(2) require each savings and loan holding company (SLHC) to file Annual and Current Reports. An Annual Report on Form H-(b)11 must be filed not later than 90 days after the fiscal year end. Current Reports, providing quarterly updates of certain information, must also be filed under cover of Form H-(b)11. Current Reports must be filed within 45 days of the end of each quarter. However, in one instance – for March 31, 1993 – CCFC failed to file its quarterly report. In another instance, the annual H-(b)11 report for the fiscal year ended June 30, 1994 was filed 7 months late and did not include financial statements for the holding company.

Moreover, CCFC's financial statements for the fiscal year ended June 30, 1995, which were due by September 28, 1995, were not provided to the examination team until October 30, 1995. According to the holding company report of examination, the delayed receipt of those annual financial statements substantially delayed completion of examinations for both the thrift and the holding company.

In the 1995 holding company report of examination, OTS notified holding company management that civil money penalties may be assessed because of continued late and incomplete filing of required reports. In 1996 the holding company was again criticized because regulatory reports lacked current financial information, but no penalties were assessed. In fact, no civil money penalties were ever assessed. Furthermore, from 1993 through 1995 Superior failed to report the payment of approximately \$12.5 million in non-cash dividends in its Thrift Financial Reports, as required. Although the payments of these dividends is discussed in holding company reports of examination, OTS never addressed Superior's failure to report them.

For more than 2 years OTS did not find transactions prohibited by the Federal Reserve Act. In addition, OTS did not properly address CCFC's late filings and failure to file required financial reports or its failure to report all dividends paid. As a result, Superior did not report more than \$12.5 million of dividends in its Thrift Financial Reports. Further, Superior made extensions of credit to its holding company and affiliates totaling \$36.7 million, in apparent violation of federal law.

Dividend Payments

Although Superior's payment of dividends to its holding companies was within federal guidelines at the time they were made, dividends paid were excessive. OTS approved Superior's requests to pay dividends without performing a thorough review and analysis of earnings. Furthermore, as a result of an accounting error and liberal assumptions used in valuing the residual interests and OC accounts, the bank's assets and capital were overstated. Concomitantly, earnings were overstated as a result of this valuation. Had these accounts been properly valued, dividend payments would have been substantially reduced or possibly even eliminated.

Superior made application to OTS for the payment of each dividend in accordance with 12 CFR. §563.134. OTS reviewed each request and did not object to the payment of any dividend. Amounts paid by Superior as dividends are shown in the following tables.

Table 18: Dividends Made by Superior Through June 30, 2001 (shown as a percentage of calendar year net income after taxes)

Calendar Year	Dividends Paid (in thousands)	Net Income (in thousands)	Percent of Net Income Paid Out
1988	\$ 0	\$ (19,901)	n/a
1989	0	3,276	0
1990	0	8,423	0
1991	0	(1,887)	n/a
1992	2,147	2,795	76.8%
1993	19,773 ¹	20,673	95.6%
1994	5,793 ¹	10,791	53.7%
1995	11,655 ¹	28,471	40.9%
1996	35,291	78,954	44.7%
1997	36,556	73,870	49.5%
1998	56,022	109,979	50.9%
1999	33,556 ²	104,887	32.0%
2000	0	(5,638)	n/a
2001 ⁴	0	(100,811) ³	n/a
Total	\$ 200,793 ⁴	\$ 313,882	75.7%

Source: Office of Thrift Supervision TFRs, Reports of Examination, and internal documents.

¹Includes more than \$12.5 million in non-cash dividends – financial receivables – that were not reported in Superior’s TFRs: \$12,018,000 in 1993, \$87,000 in 1994, and \$471,000 in 1995. Only cash dividends were reported in the TFRs: \$7,755,000 in 1993, \$5,706,000 in 1994, and \$11,184,000 in 1995.

²Includes cash totaling \$15,000,000 and financial receivables totaling \$18,556,000, all of which were reported in the TFRs.

³January 2001 through June 2001 only. Any net income or loss from July 2001, before Superior was closed, is not included.

⁴ Superior reported the payment of \$188,217,000 in dividends in its TFRs. Actual payments totaled \$200,793,000: cash of \$169,661,000; and financial receivables of \$31,132,000.

Table 19: Cumulative dividends made by Superior through June 30, 2001 (shown as a percentage of cumulative net income after taxes)

Calendar Year	Cumulative Dividends Paid (in thousands)	Cumulative Net Income (in thousands)	Cumulative Percentage of Net Income Paid Out
1988	\$ 0	\$ (19,901)	0
1989	0	(16,625)	0
1990	0	(8,202)	0
1991	0	(10,089)	0
1992	2,147	(7,294)	n/a
1993	21,920	13,379	163.8%
1994	27,713	24,170	114.7%
1995	39,368	52,641	74.8%
1996	74,659	131,595	56.7%
1997	111,215	205,465	54.1%
1998	167,237	315,444	53.0%
1999	200,793	420,331	47.8%
2000	200,793	414,693	57.3%
2001 ¹	\$ 200,796	\$ 313,882 ¹	75.7%

Source: Office of Thrift Supervision (OTS) Thrift Financial Reports, Reports of Examination, and internal documents.

¹ January 2001 through June 2001 only. Any net income or loss from July 2001, before Superior was closed, is not included.

Before 1999 OTS reviewed Superior's applications to pay dividends using the criteria contained in 12 CFR §563.134. Under those rules, tier 1 associations⁷⁷ like Superior were allowed to make capital distributions of up to the greater of (1) 100 percent of net income for the calendar year plus one-half of surplus capital calculated at the beginning of the calendar year or (2) 75 percent of net income for the most recent four quarter period. In 1999 those rules were superceded by new rules contained in 12 CFR §563.143. Generally, under the new rules OTS determines whether the payment of dividends (a) will cause the institution to become undercapitalized; (b) raises safety and soundness concerns; or (c) violates any statute, regulation, or agreement. OTS also made other evaluations of the thrift's condition.

In addition, Superior's internal dividend policy limited cash payments to the holding company to 50 percent of quarterly net income. However, Superior requested and received approval from the OTS to exceed this policy during 1993 and 1994. For example, according to the holding company report of examination for the fiscal year ended June 30, 1994, the holding company received dividends from Superior totaling slightly more than \$20 million. That amount represented 146.4 percent of Superior's \$13.7 million net income for the fiscal year. The dividends consisted of \$7.9 million in cash, \$11.8 million of R-Class securities (excess mortgage servicing rights), and

⁷⁷ Under 12 CFR §563.134(a)(8), a tier 1 association was a savings association that had capital equal to or greater than the amount of its capital requirement immediately prior to, and on a *pro forma* basis after giving effect to, a proposed capital distribution.

\$257,000 of B-Class securities.⁷⁸ In its report, OTS stated that the use of assets in the dividend payment would reduce Superior's overall level of risk and was approved by the OTS as an acceptable method of reducing the "higher risk" excess mortgage servicing rights on Superior's books. However, because of losses sustained by Superior in earlier years, that amount also represented 116 percent of Superior's total net income since inception.

OTS's holding company reports of examination and examinations of Superior also discussed Superior's payment of dividends. The reports typically stated that payment of dividends by Superior did not have an adverse effect on its compliance with capital regulations as the institution was generally classified as "Well Capitalized." Although OTS approved Superior's dividend requests as being in compliance with applicable regulations, OTS did so before it concluded that Superior's residual interests were overvalued and before the OTS performed a thorough analysis and assessment of the potential impact of imputed gains on earnings and to the institution. Because Superior's residual assets were overvalued, Superior's earnings and capital were overstated, which would have affected OTS's review and approval of Superior's dividend payments.

In addition, as explained earlier, Superior made uncollateralized extensions of credit to its holding company and affiliates totaling \$36.7 million in apparent violation of federal law, and this receivable was not repaid before Superior closed. The majority of this receivable accumulated in the third and fourth quarters of 2000 when Superior sold loans to CCFC at less than fair market value. At that time, Superior was significantly undercapitalized according to a recalculation done by OTS in Superior's March 2001 report of examination. Superior was also incurring operating losses at that time and had a composite CAMELS rating of "4." As such, it would not have been allowed to pay dividends had application been made.

Furthermore, according to OTS's March 2001 report of examination, Superior's effective earnings for the past several years were substantially less than the results reported by management on regulatory reports. Superior's earnings were also less than the results reported on the annual statements audited and verified by E&Y, the outside accounting firm. According to OTS, inflated gains on loan sales masked the true earning capability of Superior under its principal lines of business. Inefficiencies of the loan origination platform became apparent when gain on sale accounting ceased. In addition, unproductive business endeavors could no longer be supported and Superior's complicated accounting system with numerous divisions and operating units also contributed to the operational problems.

⁷⁸ At various times, Superior issued Class A, B, R, and S securities as part of its securitization transactions. Class A and Class B certificates consisted of interest bearing principal REMIC securities (REMICs are explained further in the Glossary) while the Class R and Class S certificates were interest-only REMIC securities.

OTS unknowingly allowed Superior to pay excessive dividends and to potentially cause the depletion of its capital because OTS did not thoroughly analyze and assess the bank's earnings performance as it was affected by imputed gains, and OTS did not determine that Superior's residual interests and overcollateralization accounts were overvalued until October 2000. The exact amount of excessive dividends cannot be quantified because the overvaluation of the residual interests and overcollateralization accounts affected all prior periods. In addition, Superior made non-cash dividends in the form of financial receivables that cannot be properly valued until sold.

Topic 8 - The regulators' efforts to detect the potential for bank fraud and insider abuse at Superior Bank.

The regulators did not always scrutinize “red flags” that existed at Superior. Several warning signs were clearly evident as early as 1994 that should have resulted in further investigation by the examiners. Perhaps the biggest warning sign of all was in 1996 when the bank had a Return on Assets of 7.56 percent which, at the time, was over 12 times more than that of the average thrift in the United States. Virtually all of Superior’s earnings were derived from gain on sale accounting related to securitizing subprime mortgages. While at times it appears the Office of Thrift Supervision (OTS) reviewed some of the red flags, many red flags were not fully reviewed by the OTS.

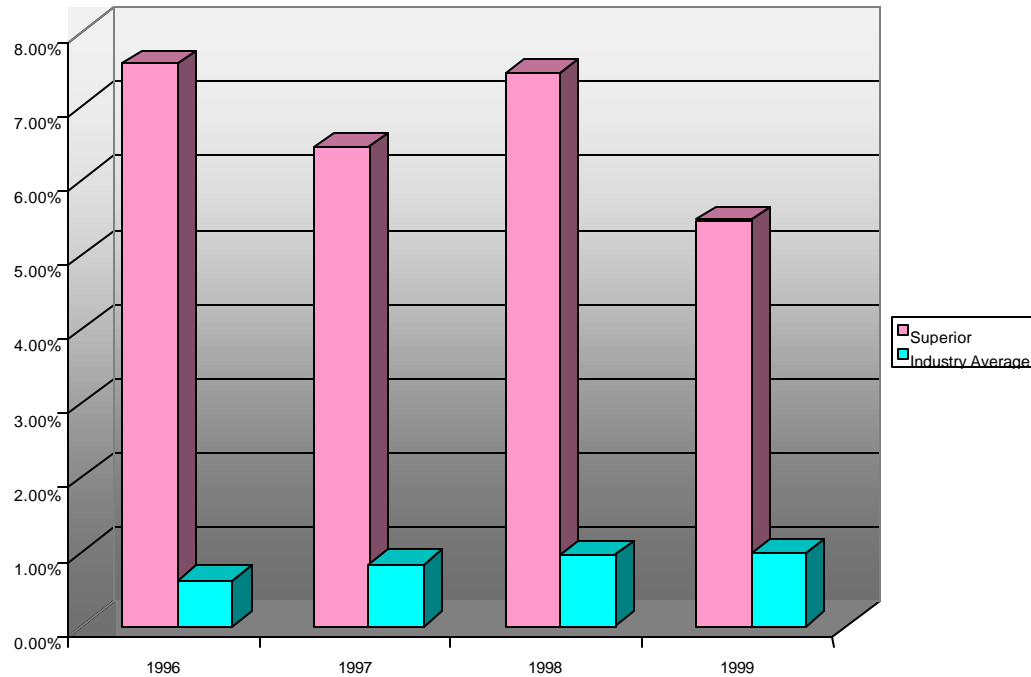
Detection of Insider Abuse and Fraud

The early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the Federal Deposit Insurance Corporation’s (FDIC) deposit insurance funds and uninsured depositors. Although it is not possible to detect all instances of apparent fraud and insider abuse, potential problems can often be uncovered when certain warning signs are evident. It is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity. We recognize that a number of factors make it difficult to measure the effects of fraud and insider abuse. Oftentimes the line between poor business judgment and fraud and abuse is difficult to draw. Nevertheless, based on our review of the failure of Superior Bank it appears that some of the decisions made by Superior management rise to the level of insider abuse.

Extraordinarily High Return on Assets

Superior had the highest Return on Assets (ROA) of any thrift in the United States for 1996. Superior’s ROA was 7.56 percent in 1996 when the average ROA for all insured Thrifts in the U.S. for 1996 was .62 percent. This trend continued until the year 2000. ROA is net income (including gains or losses on securities and extraordinary items) as a percentage of average total assets. It is the basic yardstick of bank profitability. Refer to Figure 3 for a comparison of Superior’s ROA to the industry average ROA.

Figure 3: Superior's ROA Compared to the Industry Average ROA from 1996 – 1999



Source: Superior TFR reports and OTS Thrift Industry Data Report

While ordinarily an institution with a high ROA would not be cause for regulatory concern, most of Superior's net income resulted from gain on sale accounting. Superior would generate massive amounts of subprime mortgages, securitize the loans, and then sell the security and take back an interest-only strip receivable and other residual interests. It would then book a gain on sale for the transaction. As table 20 indicates, Superior lost money every year from 1995 on before giving consideration to its gain on sale income from securitizations.

Table 20: Effect of Gain on Sale Accounting on Net Income

Calendar Year	Net operating income (000's)	Gain on Sale Income (000's)	Net Income (000's)
1994	\$3,562	\$7,353	\$10,791
1995	(1,075)	30,967	28,471
1996	(4,692)	64,727	78,954
1997	(17,813)	91,314	73,870
1998	(23,868)	137,103	109,979
1999	(26,613)	185,979	104,887
2000	(54,621)	43,372	(5,638)

Source: Superior's TFRs

To exacerbate the problem, the bank had a very large percentage of its assets in these risky and complex investments. These factors combined should have resulted in greater regulatory oversight; however, it appears the Office of Thrift Supervision did not scrutinize these transactions very much, apparently relying on verbal assurances from bank management and the opinion of the bank's external auditor, Ernst and Young.

Concentration in Residual Interests

Superior began booking residual interests in 1993 and by June 30, 1995 its residual assets⁷⁹ had reached 100.1 percent of core capital. The September 11, 1995 examination report noted "the thrift recorded \$65.8 million of residuals, which represented 100.1 percent of capital."

The October 7, 1996 examination report, in the concentration section, noted that

The thrift's major business continues to be mortgage banking. The AFC [Alliance Funding Corporation] division originates, securitizes the loans into REMICS, and sells all of the collateral classes. The thrift retains the servicing on all loans sold and the residual interest-only classes of the REMIC securities. At June 30, 1996, these residuals totaled \$148.2 million, which represented 142.0 percent of core capital. Despite continued originations and sales, the business plan shows that by June 1997, the balance of the residual interest classes will total \$198.3 million, or 148.9 percent of core capital. The amortization of the earlier residuals, the increasing level of capital, and management's plan to keep risk-based capital above 10 percent are all factors that naturally suppress this concentration from dramatically rising.

Moreover, the 1997 examination report noted the following:

The thrift's major business continues to be secondary marketing of mortgage and consumer loans. The servicing and excess interest residual classes of the REMIC and auto loan sales are retained and their imputed value is determined and recorded as assets. As of September 30, 1997, these assets totaled \$225.2 million, which represented 19 percent of total assets and 147.4 percent of tangible capital. The continued amortization of the assets, the increasing level of capital and management's plan to maintain at least 10 percent in risk-based capital mitigates the concern regarding this concentration.

The FDIC Examination Manual defines a concentration as a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity, or affiliated group. These risks may in the aggregate present a substantial risk to

⁷⁹ The residual assets consist of the residual interests and the overcollateralization (OC) account. The residual interests consist of the difference between the interest received on the underlying loans supporting the securitizations and the interest paid on the securitizations. The OC account is comprised of residual interests that are segregated into a separate account in accordance with the securitization agreement. Refer to Topics 2 and 4 for a more detailed discussion of residual interests and the OC account.

the safety and soundness of the institution. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. Where reasonable diversification realistically cannot be achieved, the resultant concentration calls for capital levels higher than the regulatory minimums.

The OTS Regulatory Handbook defines a concentration as a significantly large volume of assets that a thrift has advanced or committed to an individual or group of borrowers related by a common dependency or a common risk characteristic. Assets with a common dependency should be recognized as a concentration if they exceed 25 percent of core capital and general valuation allowances. All concentrations are not inherently objectionable, if they are properly controlled through underwriting standards. Thrift management should identify concentrations and assess their size and individual risk so policies and plans can be adjusted accordingly. At a minimum, management should identify, measure, monitor and regularly report significant concentrations to the Board of Directors to provide a basis for board policy.

Regulators should monitor concentrations and conduct a more in-depth periodic review of them than of diversified areas of the loan portfolio. Regulators should evaluate management's control of concentrations and use of diversification to limit or prevent excessive risk of loss. For unavoidable concentrations, strict underwriting standards should be followed to limit credit risk.

A review of OTS examination reports shows that although concentrations were frequently noted by examiners, there was no discussion of what bank management was doing to mitigate the risk that came with the concentrations. Nor was there any discussion of how underwriting standards were being used to control risk. We reviewed Superior's Board of Director minutes from 1995 to 1998 and did not see any discussion at the board level as to the risk these concentrations posed to the bank.

Capital was Not Commensurate with Risk

Although Superior's niche was in risky subprime lending and securitizations beginning in 1993, it was never required by OTS to increase capital commensurate with that risk until 2001. Superior's capital averaged about 11 percent from 1995 to 1999 when the average equity ratio of non-bank subprime lenders was typically over 20 percent. Superior's capital met regulatory guidelines but it fell far short of what the market generally required.

Filing of Inaccurate Thrift Financial Reports (TFR)

As early as 1996, Superior submitted TFRs that were inaccurate. For example, the September 30, 1997 TFR reported classified assets of \$5.7 million, or 2.9 percent of tangible capital. The reported classified assets consisted primarily of delinquent loans on single family residences. Management did not classify automobile loans delinquent 90 to 119 days totaling over \$4 million and repossessed automobiles and REO properties totaling over \$1.3 million. OTS examiners had to revise classified assets to \$11.3 million

or 5.8 percent of tangible capital. Bank management agreed that these assets should have been classified and stated that future supervisory reports would be accurate.

The January 1999 Examination report noted that classified assets were substantially understated on the December 31, 1998 TFR. Also, the report noted that the TFRs filed for the previous quarters of 1998 understated the level of classified assets. At December 31, 1998, Superior reported classified assets of \$32.3 million or 13.1 percent of tangible capital plus allowable allowance for loan and lease losses. During the 1999 examination, OTS revised the classification totals for December 31, 1998 to \$64.7 million, over twice what the bank had reported on its TFR.

In addition, Superior frequently showed a difference between its TFRs and financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP), especially relating to the financial receivables and reserve accounts. Since TFR instructions indicate these items should be shown in accordance with GAAP, there would be no reason for these reporting differences (Refer to Topic 3 for a discussion of TFR errors.) Also, lax charge-off procedures related to auto loans were noted at the bank. The bank was reporting auto loss classifications on internal reports but not reflecting the losses on regulatory reports.

The Internal Audit Process Was Limited

According to the Director of Internal Audit, audit committee meetings were very infrequent, and bank management did not address numerous audit items. Moreover, the operations at Superior-affiliate Fintek, whose President was also Superior's Chairman, were considered "off-limits" to the internal audit department even though the affiliate calculated the value for residual interests in addition to providing vital investment, liquidity, and overall financial advisory services to Superior.

One of the primary objectives of the OTS's March 2001 examination was to determine if the residual assets were being properly valued, after the October 16, 2000 field visitation disclosed that the institution's external auditors, Ernst & Young (E&Y), did not appropriately advise Superior how to account for a portion of the residual assets in accordance with GAAP. A recalculation of the OC account, one of the components of the residual assets, resulted in a mandatory write-down of \$270 million as of December 31, 2000. On March 2, 2001, Superior amended its December 31, 2000 Call Report to reflect a more accurate value of the OC account. The amendment caused the institution to be downgraded from "adequately capitalized" to "significantly undercapitalized." At the conclusion of the March 2001 OTS examination, an additional \$150 million write-down was needed to accurately reflect the value of the residual interests. Had the internal audit department been free to review Fintek operations, the inadequate support for the valuation assumptions used might have been detected earlier.

Questionable Management Practices

Questionable management practices were evident at Superior for many years. Although examiners eventually detected most of the problems, it appears that prior to the year 2000, OTS did not sufficiently follow up on the warning signs.

In 1996, the holding company CCFC made a \$70 million loan to UBH, Inc., one of the holding companies that owned Coast-to-Coast Financial Corporation. According to the promissory note dated March 29, 1996, partial interest payments were to be made monthly through July 1997. The remainder of the interest and all of the principal was to be paid in one installment on December 31, 1999. We could not find any evidence that any payments were made on this loan. OTS officials also questioned whether UBH, Inc. ever made any payments to the holding company for this loan. This money could have been made available to Superior when its capital levels fell shortly after the loan payment was due. Since the terms and conditions of the loan are somewhat vague and no loan payments were apparently made, it raises the question whether this was actually a dividend payment rather than a loan.

An example of questionable management practices was illustrated during the January 2000 examination. OTS examiners found a \$12 million discrepancy in problem assets reported by the bank as of December 31, 1999. Upon investigation by the examiners, it was discovered that the \$12 million in problem assets had in fact been sold to an advertising agency. Basically the bank had swapped \$12 million worth of repossessed autos and liquidated deficiencies for credits on future advertising placed with an advertising agency. To obtain the credits, Superior would have to spend \$67.3 million within 4 years at prices determined by the advertising agency. No previous advertising had been placed with this advertising agency. The OTS Regional Accountant determined that the transaction had little or no value and Superior had actually received assets that were inferior to those that were traded. Consequently, OTS required the bank to charge-off the entire \$12 million in future advertising credits.

Another example of a questionable practice was identified by OTS examiners during the March 2001 examination. The examiners uncovered a series of transactions involving the bank and its holding company where the holding company appeared to benefit from terms and conditions that were not at arm's length and that were detrimental to the bank. These transactions totaled almost \$37 million and violated various statutes and regulations. For example, examiners discovered that during the fourth calendar quarter of 2000 Superior sold loans at a fixed price to CCFC. CCFC then quickly resold the loans and reaped over a \$20 million gain on the transaction. This transaction violated various federal regulations by selling assets to an affiliate at a price less than fair market value.

Section 360 of the OTS Regulatory Handbook, Thrift Activities, identifies certain red flags that examiners should be looking for and notes that appropriate measures should be taken to follow up. It appears that examiners may have relied too much on bank management assertions, representations from the bank's external auditors, and the reported wealth of the owners of the holding company. According to the

January 2000 examination report, failure was not considered likely due to the overall strength, financial capacity, and support of the ownership interests.

It does not appear that OTS performed an extensive analysis of the model used by the bank in determining the carrying value of the residual interests. Assumptions used by the bank appear to have been accepted without comparison to other banks and entities in the same line of business. A solid internal control structure and risk management program was not in place at Superior.

As a result, the bank had grossly inflated earnings from 1996 through 1999. The owners received over \$200 million in dividends during the 1990s, most of which occurred between 1995 and 1999. When OTS was not critical of the bank during the earlier examinations, it may have contributed to the bank's unbridled growth into subprime lending and securitizations.

Topic 9 - Any issues regarding the lack of coordination or communication between the OTS and the FDIC and between the OTS' regional and home offices.

Our analysis determined that the most critical issue regarding the lack of coordination and communication between the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC) occurred when OTS denied the FDIC's on-site participation in the January 1999 OTS safety and soundness examination. The FDIC's request to have one examiner onsite was denied by the OTS; however, the FDIC ultimately agreed to a less satisfactory arrangement of meeting OTS examiners off-site during the examination. Although the FDIC has special examination authority under section 10(b)(3) of the Federal Deposit Insurance Act to make any special examination of any insured depository institution for insurance purposes, there are required procedures that can inhibit timely and justified access. If the FDIC had participated in the examination, the two regulators working together may have been more effective in minimizing the losses to the Savings Association Insurance Fund.

FDIC Requests To Participate in OTS Safety and Soundness Examination

In December 1998, a Division of Supervision case manager from the Federal Deposit Insurance Corporation's (FDIC) Chicago Regional Office (DOS case manager) concurrently conducted the quarterly (9/30/98) Billion Dollar Insured Deposit Institution (BIDI) off-site review and a review of audited financial statements for Superior Bank. The DOS case manager observed that Superior Bank exhibited a high-risk asset structure. He observed significant investments in the residual values of the securitizations of loans that exhibited interest rates substantially higher than peer institutions. He stated that although Superior Bank had not been identified as a subprime lender in the past, the high interest rates were characteristic of such portfolios. He also observed that Superior's June 30, 1998 Thrift Financial Report reflected Allowance for Loans and Lease Losses amounts that were about twice the amounts that could be determined from the audited financial statements.

The DOS case manager contacted the Office of Thrift Supervision (OTS) Central Regional Office field manager (OTS field manager) responsible for Superior Bank to discuss his observations and concerns. According to the DOS case manager, despite Superior's unusual operational characteristics, the OTS field manager had no significant concerns, in part because Superior management was well regarded by OTS. Based upon the DOS case manager's belief that the concentration in subprime lending warranted closer supervision, he recommended that the FDIC participate in the OTS's next safety and soundness examination of Superior Bank which was scheduled to start in January 1999.

The FDIC's special examination authority is contained in subsection 10(b)(3) of the Federal Deposit Insurance Act, 12 USC §1820(b)(3). The law provides the FDIC Board of Directors with the power to authorize special examinations of any insured depository institution to determine its condition for insurance purposes. On March 9, 1995, the FDIC Board of Directors delegated authority to the FDIC Director of DOS to conduct examinations, visitations, and/or other examination activities for insurance purposes as follows:

- 1) Examinations, visitations or similar activities when the primary federal regulator has invited FDIC participation;
- 2) Examination activities associated with CAMEL 4 and 5 rated institutions or situations of potential or likely failure of an institution within a 1-year time frame when the primary federal regulator does not object to the FDIC's participation; and
- 3) Examination activities where there are material deteriorating conditions not reflected in the current CAMEL rating and the primary federal regulator does not object to FDIC participation.

The foregoing authority is subject to meeting the following standards:

- 1) Potential or likely failure of an institution within a 1-year time frame, or
- 2) Reasonable basis for believing that an institution represents a greater than normal risk to the insurance fund and data available from other sources is insufficient to assess that risk.

All other requests are required to be presented to the FDIC Board of Directors for decision.

Based upon the FDIC Board's delegated authority, the FDIC appropriately established a reasonable basis of identifying risk to the insurance fund and acted within its authority to request participation in the OTS's next scheduled safety and soundness examination. However, the FDIC had to seek approval from the OTS to participate in an examination.

OTS Denies FDIC's Participation in the January 1999 Examination

The DOS case manager responsible for monitoring Superior Bank contacted the OTS field manager on December 22, 1998 to ask if one FDIC examiner could participate in the next OTS examination scheduled during January 1999. The OTS field manager responded that the FDIC would have to make a formal written request to the OTS Central Regional Office Regional Director (OTS Regional Director). A formal written request dated December 28, 1998 was addressed to the OTS Regional Director from the FDIC DOS Chicago Region Regional Director (DOS Regional Director).

The OTS regional office officials had concerns with the FDIC's request to participate in the January 1999 safety and soundness examination. The OTS field manager did not think it would be a good idea because Superior Bank had a lawsuit⁸⁰ in process against the FDIC. In an e-mail sent to the OTS Central Regional Office Regional Deputy Director (OTS Regional Deputy Director) notifying him of the FDIC's oral request and forthcoming written request, the OTS field manager stated that,

Superior has always been very cooperative with OTS and I wouldn't want to jeopardize our working relationship with Superior. I know that Superior's management has a poor opinion of the FDIC and I think that Superior would be very upset if the FDIC were to come in with us.

The OTS Regional Deputy Director forwarded the field manager's e-mail to the OTS Regional Director and added the following comments,

While I feel [Superior Bank] management here at the local level is far enough removed from the litigation with the FDIC, [Superior Bank's Chairman of the Board] is not. However, if the FDIC is interested in the capital markets area, [Superior Bank's Chairman of the Board] is likely to be very involved in the capital market discussions. Bottom line is the FDIC still needs to convey a good reason for why they want to join us. We'll just have to wait and see.

It appears that a miscommunication involving the issuance and receipt of the formal written request by the DOS Regional Director to the OTS's Regional Director compounded the back-up examination access issue with a critical delay. According to OTS management officials interviewed during our review, they never saw the written request from the FDIC and only learned of the existence of the written letter after Superior failed in July 2001.

Because the FDIC had not received a response from OTS, the DOS Regional Director telephoned the OTS Regional Director on Friday, January 15, 1999 just 4 days prior to when the FDIC believed the OTS examination of Superior Bank was to commence. According to the DOS Regional Director, during this telephone call, the OTS Regional Director verbally denied the FDIC's request to join the OTS examination. The reason given to the DOS Regional Director was that Superior Bank had been rated a CAMEL composite "1"⁸¹ at its last examination in 1997 and it was not the regular practice of the

⁸⁰ There were unresolved issues between the bank and the FDIC related to the interpretation and administration of the Federal Savings and Loan Insurance Corporation (FSLIC) Assistance Agreement, including such items as the carrying amount of covered assets, timing of certain payments and reimbursements of certain expenses. The bank intended to pursue recovery from the FDIC.

⁸¹ CAMEL Composite "1" rating -Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

FDIC to participate in OTS examinations of thrifts with such ratings. The OTS Regional Director said that to his knowledge, the FDIC had not previously requested to participate in any examination of an institution rated a CAMEL composite “1” or “2.” In addition, OTS raised concerns over possible negative perceptions that an on-site FDIC presence might cause due to the litigation between Superior Bank and the FDIC.

According to FDIC officials, OTS never discussed the intent of the FDIC’s request during the telephone conversation. The OTS Regional Director did propose an off-site meeting between the OTS examiners and the FDIC Regional Capital Markets Specialist. According to Chicago DOS officials, they were not in favor of the proposed arrangement, but given that the examination was to start the following week, they accepted the offer.

Although OTS acted in accordance with established guidelines in denying the FDIC’s request to participate in the 1999 examination, it does not appear that OTS had justifiable reasons for its decision. The OTS Central Regional Office officials raised their concerns regarding the ongoing litigation between the FDIC and Superior Bank. The litigation involving the assistance agreement originally made between the Federal Savings and Loan Insurance Corporation and Superior Bank was related to the FDIC’s Division of Resolutions and Receiverships and not the FDIC’s Division of Supervision. We asked OTS management officials if they had consulted with OTS Office of General Counsel to determine if there was a potential conflict of interest. They responded that they had not asked for legal input.

In an interview with the OTS field manager, he explained that Superior’s management was concerned about the lawsuit and that they were “paranoid” about what OTS was sharing with the FDIC. The OTS Regional Director told us that the bank’s employees were afraid that the FDIC wanted to obtain information regarding the litigation rather than examination information. He added that there “may have been more animosity had the FDIC been on-site.”

Based upon their actions, it appears that OTS regional office officials either felt that the FDIC did not have a reasonable basis for believing Superior Bank represented a greater than normal risk to the insurance fund or that the litigation issues outweighed the FDIC’s concerns.

Access Issues Were Not Elevated to FDIC and OTS Headquarters

OTS issued a Regional Directors Memorandum on April 5, 1995 entitled *FDIC Participation on Examinations*. The memorandum requires that all FDIC requests to participate in OTS examinations be submitted to the OTS Regional Directors in writing. It also states that if the OTS Regional Director does not concur with the request, copies of all relevant correspondence should be forwarded to the OTS Director of Supervision in Washington, D.C. The OTS Director of Supervision will review the request and if the OTS Director concurs with the decision to deny the request, the OTS Director will notify the FDIC Director of Supervision of OTS’s position so that the FDIC can move it forward to the FDIC board for resolution. OTS management officials claim to have

never seen the FDIC's written request, so it can be argued that there was no written request to advance to Washington, D.C.

In accordance with the FDIC Board of Directors' delegated authority, if the primary regulator objects to the FDIC's back-up examination request, the FDIC's alternative is to present a formal case to the FDIC's Board of Directors. When the OTS Regional Director refused the FDIC's request on January 15, 1999, the DOS Regional Director's understanding was that the examination was going to commence on the following business workday.

We asked the DOS regional officials why they did not raise the issue to Washington. The Regional Director's response was that it would have been too late, as it would have taken a Board resolution, and that would have taken too much time under the circumstances. He added that it would have been difficult, without having more detailed information, to present a solid case to the Board that the FDIC needed on-site access to a "1" rated institution as well as the fact that independent bond rating agencies had given Superior high ratings.

Regardless of whether a formal written request was sent or received, both the FDIC and OTS regional management officials were aware of each other's concerns and should have elevated the issues to their respective headquarters offices in Washington, D.C. It is possible that the access issues could have been resolved without presenting a formal request to the FDIC's Board of Directors.

Impact on Losses to the Insurance Fund

The FDIC was unable to thoroughly and effectively evaluate the risks inherent in the Bank's securitizations of subprime mortgage loans in early 1999. Subsequently, the institution dramatically expanded its portfolio of high-risk residuals that eventually contributed to the high losses incurred at the time of failure.

In her October 2001 testimony to the Senate Committee on Banking, Housing, and Urban Affairs (Senate Banking Committee), the OTS Director softened the 1999 examination denial by stating,

...it is important to recognize what happened next, which is...they reached an agreement that the OTS would pass on all its exam work papers and make available to the FDIC all of its examiners before the exam ended as a conduit to bring anything back that the FDIC wanted to have brought back.

In our discussions with the FDIC examiners, we were told that OTS delayed the agreed upon meeting twice and that the meeting did not take place until the last week of the examination. The FDIC examiners said that they did not get sufficient information and/or answers to their questions from the OTS examiners. They added that even though OTS examiners reviewed some of the same areas that the FDIC examiners would have reviewed at the examination, they do not conduct their review in the same manner as the

FDIC examiners. For example, the OTS examiners reviewed the asset valuation account; however, according to DOS examiners, it was not reviewed at the same depth in which the FDIC examiners would have conducted the review. Even at the January 2000 examination of Superior Bank in which the FDIC participated, OTS did not review the valuation account in any great detail. The FDIC examiners told us that after their discussions with the OTS examiners, they felt more than ever that they needed to gain on-site access.

As a result of the 1999 safety and soundness examination of Superior Bank, the OTS downgraded the thrift to a CAMEL Composite “2.” According to the OTS Regional Deputy Director, the reasons the rating was lowered included interest rate concerns, the slipping of asset quality in the auto lending program, and the earnings retention based primarily on gain of sale accounting. The FDIC case manager believed the rating was at best a “3” and probably a “4.” However, the FDIC did not have sufficient information to justify a downgrade to a “4.”

While it is not feasible for us to quantify in dollars whether or how much of the losses in high-risk residuals could have been prevented had the FDIC participated in the 1999 OTS examination of Superior Bank, there are certain facts that are clear:

- The FDIC was denied on-site access to participate in OTS’s January 1999 examination of Superior. The OTS rated the thrift a “2” and the FDIC rated the thrift a “3.”
- The FDIC was subsequently permitted to participate in OTS’s January 2000 examination. (The OTS initially rated the thrift a “3,” and the FDIC rated the thrift a “4.” OTS subsequently lowered its rating to a “4.”)
- Superior stopped creating residual interests (at the thrift level) less than 6 months following the 2000 examination in which the FDIC participated.
- Superior booked \$272.2 million in residual interests between June 30, 1999 and June 30, 2000 (starting six months after the January 1999 examination).

The FDIC’s capital markets specialist instrumental in identifying the residual interest valuation issues, was planning to participate in the 1999 examination and ultimately participated in the 2000 examination. He believes that he would have had the same questions in 1999 as he did after the 2000 examination. He also believes that he would have pursued answers in the same manner and perhaps reached the same conclusions. It is apparent that the FDIC’s eventual participation had an impact on the federal regulatory oversight of Superior Bank and that the impact could have been more beneficial with earlier on-site access.

In his October 2001 testimony to the Senate Banking Committee, the FDIC Director, made the following observations:

...two sets of eyes, earlier in the process, might have mitigated a portion of the loss to the insurance funds. In part, this [access issue] is a shortcoming of the FDIC Board's own internal procedures. We intend to review, in fact we are reviewing whether our own Board's special insurance examination policy is inhibiting our ability to determine the risks which non-FDIC supervised institutions pose to our funds.

Special Examination Authority Procedures Can Inhibit Timely and Justified Access

In our October 19, 1999 Audit Memorandum to the Chairman – *Results of OIG Review of the Backup Examination Process and DOS's Efforts to Monitor Megabank Insurance Risks*, we suggested that the FDIC Chairman request delegated authority from the FDIC Board to initiate special examinations without having to secure the concurrence of the primary federal regulator or the FDIC Board of Directors; or seek a legislative change to vest this authority in the FDIC Chairman.

Following the failure of the Bank of Keystone in September 1999 and the issuance of the FDIC Office of Inspector General's October 1999 memorandum, the House Committee on Banking and Financial Services proposed legislation designed to strengthen the FDIC's ability to monitor and assess risk in those financial institutions for which the FDIC is not the primary regulator. Following a hearing on February 8, 2000, no action was taken on the legislation on the strength of the Comptroller of the Currency's representations during the hearing that there should be no problems with the FDIC's access to banks and that any disputes with the FDIC would be resolved at his level. Also during the hearing, the OTS Director made the following statement in her testimony:

With respect to our policies regarding FDIC participation in OTS examinations and FDIC requests to examine OTS-supervised thrifts, we have only one policy—the door is always open. We have told our regional directors that whenever the FDIC asks to go into a thrift, that request must be honored. If there are concerns—for example when the FDIC is involved in ongoing litigation against the institution – these are to be brought to the immediate attention of senior Washington staff so they can be quickly evaluated and resolved on a consistent basis. A second set of eyes is a benefit when an institution is showing signs of stress, and in numerous instances we have sought out FDIC participation in examining a problem institution.

The OTS Director did not believe that legislation was necessary and that the legislation could run counter to productive interagency coordination. She made the following statement:

In my over-two-year tenure on the Board of the FDIC, no OTS backup supervision case has ever been brought to the Board, yet there has been effective OTS/FDIC coordination. The existing system of interagency coordination has worked well. Given the productive relationship we have with the FDIC as well as the mutual benefits arising out of FDIC's involvement in our supervision of thrift institutions, I believe this legislation is not needed.

As was mentioned earlier in this report, there was a reluctance on the part of the FDIC examiners to raise their concerns to the FDIC's Board of Directors, which under current governing regulations was their next level of recourse. Their reluctance was based primarily on the absence of time and the lack of detailed information needed to support a case to the FDIC Board especially since Superior's last rating by the OTS was a composite "1."

In his October 2001 testimony to the Senate Banking Committee, the FDIC Director made the following observations with respect to the current rules under which the Board operates with respect to the FDIC's special examination authority:

...in 1995, during a time when the FDIC Board was shorthanded and was composed of just three members – the FDIC Chairman, the OCC Comptroller of the Currency and the Director of OTS, there was a Board Resolution passed by a vote of 2-1 which prohibited the FDIC from exercising backup authority unless it was brought to the attention of the Board of Directors of the FDIC. This had an inhibiting impact on our ability to engage in backup examination authority. And it is always a risk that will exist as long as the Board is comprised of members, of the current membership of the Board, and it jeopardizes the FDIC when we do not have a full Board and places the Chairman of the FDIC, potentially, at a disadvantage, unfortunately, in instances that could only be described as turf wars with the other regulators.

During the 4th quarter of 2001, the FDIC Chairman directed the FDIC officials to work with the Office of the Comptroller of the Currency, Federal Reserve Board, and OTS in an effort to develop an agreement that would improve the Corporation's access to banks for purposes of performing special examinations and to provide DOS with more timely data on large banks. On January 29, 2002, the FDIC Board approved the agreement.

As the insuring agency, the FDIC strives to keep abreast of developments that occur in all institutions to determine their potential risks to the deposit insurance funds. Under the current established guidelines, when the primary regulator objects to the FDIC's participation in an examination, a well-prepared and documented case must be presented to the FDIC Board of Directors. While this process can be time consuming, it also can inhibit examiners from immediately pursuing and verifying apparent or suspected risks

that cannot be positively substantiated. The FDIC Manual of Examination Policies provides the following:

The examination function lies at the heart of the FDIC's ability to maintain public confidence in the integrity of the banking system and in individual insured institutions. Given the fundamental reasons for conducting a bank examination, access to all records and employees of the bank must be made available to the supervisory staff during an examination.

When the FDIC identifies concerns and wants to gain a better understanding of the risks through an on-site presence, the FDIC should have unobstructed access.

GLOSSARY

Allowance For Loan And Lease Losses (ALLL)	<p>Federally insured depository institutions must maintain an ALLL at a level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.</p>
Billion Dollar Insured Depository Institution (BIDI)	<p>The primary focus and purpose of the BIDI program was to determine the continued applicability of the currently assigned FDIC composite rating. Benefits of the program include:</p> <ul style="list-style-type: none"> • Support for the Large Insured Depository Institution LIDI program by providing analysis of individual institutions • Support for the risk based premium system by providing timely ratings review • Identification of potential ratings differences with primary regulators • Analytical support for interim rating change documentation <p>Note: The BIDI program was canceled in September 1999.</p>
Call Report	<p>An institution's quarterly Consolidated Report of Condition and Income which contains a balance sheet, income statement, and other detailed financial schedules containing information about the institution.</p>
CAMEL(S) Rating	<p>Financial institution regulators use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's Performance. Areas of financial and operational concern are evaluated and given a numerical rating of "1" through "5," with "1" having the least concern and "5" having the greatest concern. The performance areas, identified by the CAMEL acronym are: Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity. A sixth component, Sensitivity to Market Risk, Was added in January 1997 changing the acronym to CAMELS.</p>
Cease and Desist Order (C&D)	<p>A formal enforcement action issued by the regulator's Board Of Directors to a bank or affiliated party to stop an unsafe or Unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is not longer needed or the bank has materially complied with its terms.</p>

Composite Rating	An overall rating given to a bank based on the six components of the CAMELS rating. A rating of “1” through “5” is given, with “1” having the least regulatory concern and “5” having the greatest concern. A description on the graduations utilized in conjunction with the performance ratings is as follows:	
	Rating “1”	Indicates strong performance, significantly higher than average.
	Rating “2”	Reflects satisfactory performance, performance which is average or above: this includes performance that adequately provides for the safe and sound operation of the bank.
	Rating “3”	Represents performance that is flawed to some degree and as such is considered fair. It is neither satisfactory nor unsatisfactory but is characterized by performance that is below-average quality.
	Rating “4”	Refers to marginal performance, significantly below average. If left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.
	Rating “5”	Considered unsatisfactory; performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, threatens the viability of the institution.
Concentration	A concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentrations schedule is one of the pages that may be included in the Report of Examination. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital.	
Credit Enhancements	Credit enhancements may be either internal or external. Internal enhancements are created by redirecting internal cash flows. Examples include senior-subordinated structures and cash reserve accounts funded by the originator. External credit enhancements are not dependent on redirecting internal cash flows. Examples include letters of credit issued by banks, surety bonds issued by insurance companies, guarantees issued by financial assurance companies, and subordinated loans from third parties.	

Discount Rate	This is the interest rate used to convert future receipts or payments to their present value.
Division of Resolutions and Receiverships (DRR)	The division of the FDIC which plans and handles the resolution of failing and failed FDIC-insured institutions.
Excess Spread	This is the difference between the stated rate of return received on the loans and the stated rate of return paid on the securities.
Leverage Capital	Banks must maintain at least the minimum leverage requirements set forth in Part 325 of the FDIC Rules and Regulations 12 CFR §325.3. The minimum leverage requirement is a ratio of Tier 1 (Core) capital to total assets of not less than 3 percent or greater, depending upon the condition of the institution.
Overcollateralization	This is a type of credit enhancement in which the principal amount of collateral used to secure a given transaction exceeds the principal of the securities issued.
Par Value	The nominal or face value of a stock or bond certificate or loan. It is expressed as a specific amount marked on the face of the instrument. Par value is not related to market value, which is the amount a buyer is willing to pay for an item.
Prompt Corrective Action (PCA)	Part 325 of the FDIC Rules and Regulations, 12 CFR §325.101, et. seq, implements section 38 of the FDI Act, 12 USC §1831(o), by establishing a framework for taking prompt supervisory actions against insured nonmember banks that are not adequately capitalized. The following codes are used to describe capital adequacy: <p style="text-align: center;"> W Well Capitalized A Adequately Capitalized U Undercapitalized S Significantly Undercapitalized C Critically Undercapitalized </p>
REMIC –Real Estate Mortgage and Investment Conduit	A type of collateralized mortgage obligation (CMO). REMICs divide cash flows into two different classes – regular and residual. Investors in each class receive payments of distinct priorities and timing. The regular-class instruments are classified as debt; residual-class instruments are classified as assets.
Residual Interests	Residual interests represent claims on the cash flows that remain after all obligations to investors and any related expenses have been satisfied. They represent funds required to build reserves and pay loan losses, servicing fees, and liquidation expenses.
Risk-Based Capital	A “supplemental” capital standard under part 325 of the FDIC Rules and Regulations, 12 CFR §325, Appendix A. II. Under the risk-based framework, a bank’s qualifying total capital base consists of two types of capital elements, "core capital" (Tier 1) and "supplementary capital" (Tier 2) less certain deductions.

Risk-Weighting Assets	A system of calculating the risk-weighting of assets based on assigning assets and off-balance assets into broad risk categories, 12 CFR §325, Appendix A.II.
Section 10(b) of the FDI Act	Section 10(b), 12 USC §1820 (b) lists the power of the Board of Directors to appoint examiners to conduct regular and special examinations of financial institutions. Also, examiners shall have the power, on behalf of the Corporation, to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully the relationship between the institution and its affiliate and the effect of the relationship on the institution.
Section 10(c) of the FDI Act	Section 10(c) of the FDI Act, 12 USC §1820(c), authorizes the representative of an appropriate Federal banking agency to administer oaths and affirmations, and to examine and take and preserve testimony under oath as to any matter in respect to the affairs or ownership of any such bank, institution or affiliate.
Section 23(a)	Section 23(a) of the Banking Affiliates Act of 1982, 12 USC §371(c), establishes restrictions on transactions between financial institutions and their affiliates. These include restrictions on the dollar amount involved in the transactions and establishes collateral requirements for certain transactions with affiliates.
Section 23(b)	Section 23(b) of the Banking Affiliates Act of 1982, 12 USC §371(c)-1, places restrictions on transactions with affiliates. It requires transactions to be on the same terms and standards or at least as favorable as those prevailing for comparable transactions with a nonaffiliate. In the absence of comparable transactions, they must be on terms and circumstances that in good faith would be offered to or apply to nonaffiliated companies.
Sold With Recourse	A general ledger term meaning that the purchaser of a financial asset from an original creditor has a claim on the original creditor in case the debtor defaults. Specific arrangements to provide recourse arise in a variety of innovative transactions, including various types of securitized assets. Such arrangements can take many forms, including an explicit guarantee that credit losses will be reimbursed or the assets replaced by assets of similar quality or indemnification by a third-party guarantor for any losses.
Subprime borrower	A borrower whose credit is below good credit standards. These borrowers pose a greater risk and are characterized by paying debts late, filing for personal bankruptcy and/or having an insufficient credit history.
Thrift Financial Report (TFR)	OTS regulation, 12 CFR §562.1, requires the completion of the Thrift Financial Report (TFR) by all savings associations and affiliates. The TFR is filed electronically on a quarterly basis and is due no later than 30 days after quarter end, except for Schedule HC, Thrift Holding Company, and Schedule CMR, Consolidated Maturity and Rate, which are due no later than 45 days after quarter end. The TFR contains 14 schedules, which include financial statements and supplemental information filed on the thrift and its subsidiaries. All information on the TFR, including income and expense and cash flow data, is reported on a quarterly basis.

Thrift Institution	12 USC §1841(I) defines a “thrift institution” as: (a) a domestic building and loan or savings and loan association (b) non-profit cooperative bank without capital stock (c) a federal savings bank, or (d) a registered state-charted savings bank and holding company.
Tier 1 (Core) Capital	Defined in Part 325 of the FDIC Rules and Regulations, 12 CFR §325.2 (A), and is the sum of : <ul style="list-style-type: none"> • Common stockholder’s equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale securities with readily determinable market values); • Non-cumulative perpetual preferred stock • Minority interest in consolidated subsidiaries; Minus <ul style="list-style-type: none"> • Certain intangible assets; • Identified losses; • Investments in securities subsidiaries subject to section 337.4; and • Deferred tax assets in excess of the limit set forth in section 325.5(g).
Tier 1 Leverage Capital Ratio	Tier 1 Capital divided by total assets 12 CFR §225, Appendix D.,II.a.
Tier 2 (Supplemental) Capital	Tier 2 Capital is defined in Part 325 of the FDIC Rules and Regulations, 12 CFR §325, Appendix A., I.A.2, and generally consists of: <ul style="list-style-type: none"> • Allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets; • Cumulative perpetual preferred stock, long-term preferred stock and Related surplus; • Perpetual preferred stock (dividend is reset periodically); • Hybrid capital instruments; • Term subordinated debt and intermediate-term preferred stock; and • Eligible net unrealized holding gains on equity securities.
Total Risk-Based Capital Ratio	The total qualifying capital divided by risk-weighted assets 12 CFR §325.2(w).
Uniform Thrift Performance Report (UTPR)	A report comparing an individual bank to its peer group.

Objectives, Scope and Methodology

We conducted this review at the request of Senator Sarbanes, Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. The objectives of our review were to analyze the causes of Superior's failure and to address nine topics requested by Senator Sarbanes related to the failure. The scope of the review included an analysis of Superior's operations from 1991 until its failure on July 27, 2001. We also evaluated the regulatory supervision of the institution over the same time period. We did not include audit tests and procedures beyond those needed to answer the stated objectives.

To accomplish our review objectives, we performed the following procedures and techniques:

- Analyzed examination and visitation reports prepared by the OTS from 1991 until 2001;
- Analyzed memorandums, visitation, and draft reports prepared by the FDIC from 2000 until 2001;
- Interviewed OTS management in Washington, D.C. and Chicago, Illinois;
- Obtained information from the Legal Counsel from the OTS Chicago Regional Office;
- Interviewed FDIC DOS examiners, case managers, capital markets specialists, and executive personnel from the Chicago Region;
- Interviewed FDIC Legal Division officials at the Chicago Regional Office and Washington D.C.;
- Interviewed FDIC DRR officials in Washington, D.C. and the Dallas Regional Office;
- Interviewed OTS examiners, capital markets specialists, and executive personnel from the Chicago Region;
- Interviewed FDIC accounting specialist and OTS Chief Accountant in Washington, D.C.;
- Researched residual interests;
- Researched Section 38 of the FDI Act;
- Researched 12 CFR Part 570;
- Reviewed OTS case files in Washington, D.C. and Chicago, Illinois;
- Reviewed DRR files relating to the closing of Superior;
- Reviewed records subpoenaed from Ernst and Young (E&Y);
- Reviewed pertinent OTS policies and procedures.

We performed the fieldwork at the DOS and OTS Regional Offices in Chicago, Illinois; the OTS and the FDIC Washington, D.C. Offices; the DRR office in Dallas, Texas; and DRR offices in Washington, D.C.

We conducted our review between August 1 and December 31, 2001, in accordance with generally accepted government auditing standards. However, the scope of our review was limited by the following factors:

- It is possible that some records may have been removed or misplaced in the process of closing the institution and were not available for our review.
- We are not certain that we received all records related to Superior that were in the possession of Ernst & Young and some records that were subpoenaed from E&Y were received too late in our field work to be fully analyzed.
- We did not have access to bank records other than those that were in the possession of the regulatory authorities or E&Y.
- We did not interview E&Y or bank management officials.

Introduction to the Securitization Process

In order to fully assess the activities at Superior Bank, FSB, a description of the securitization process and the various elements that are involved is necessary. The following information is provided to enable the reader to understand the operation of the securitization process. Once this is accomplished, Superior's activities and the accounting methods that they used will be more understandable.

The Definition of the Securitization Process

By definition, securitization is the process where interests in loans, generally mortgages, and other receivables, including credit cards and automobile loans, are packaged, underwritten, and sold in the form of asset-backed securities (ABS). One of the benefits of the securitization process is that it converts relatively illiquid assets (loans), into readily marketable securities with reasonably predictable cash flows. For financial institutions, it provides more liquidity, along with other benefits such as lower funding costs, a new source of servicing income, improved financial indices, potentially lower regulatory capital requirements, and added protection from interest rate risk.

For investors, the securitization process permits them to acquire a security with relatively no or minimal credit risk. The use of either internal or external (or both) credit enhancements also helps to insulate the investor from the credit risks associated with the loan portfolios.

The Securitization Process and the Parties Involved

In its simplest form, the securitization process begins with consumers borrowing money from a financial institution. The financial institution will accumulate the various loans that it wants to securitize, for example residential mortgages. Once a certain optimum level of loans has been funded, the institution will segregate the loans into homogeneous pools with respect to cash flow characteristics or risk profiles. At this point, a trust or special purpose corporation (SPC), which is usually a bankruptcy-remote entity, is formed. The loan pools are then transferred to the SPC.

A trustee is retained to administer the trust that holds the underlying ABS collateral, the loans. The trustee's responsibilities can include the following functions:

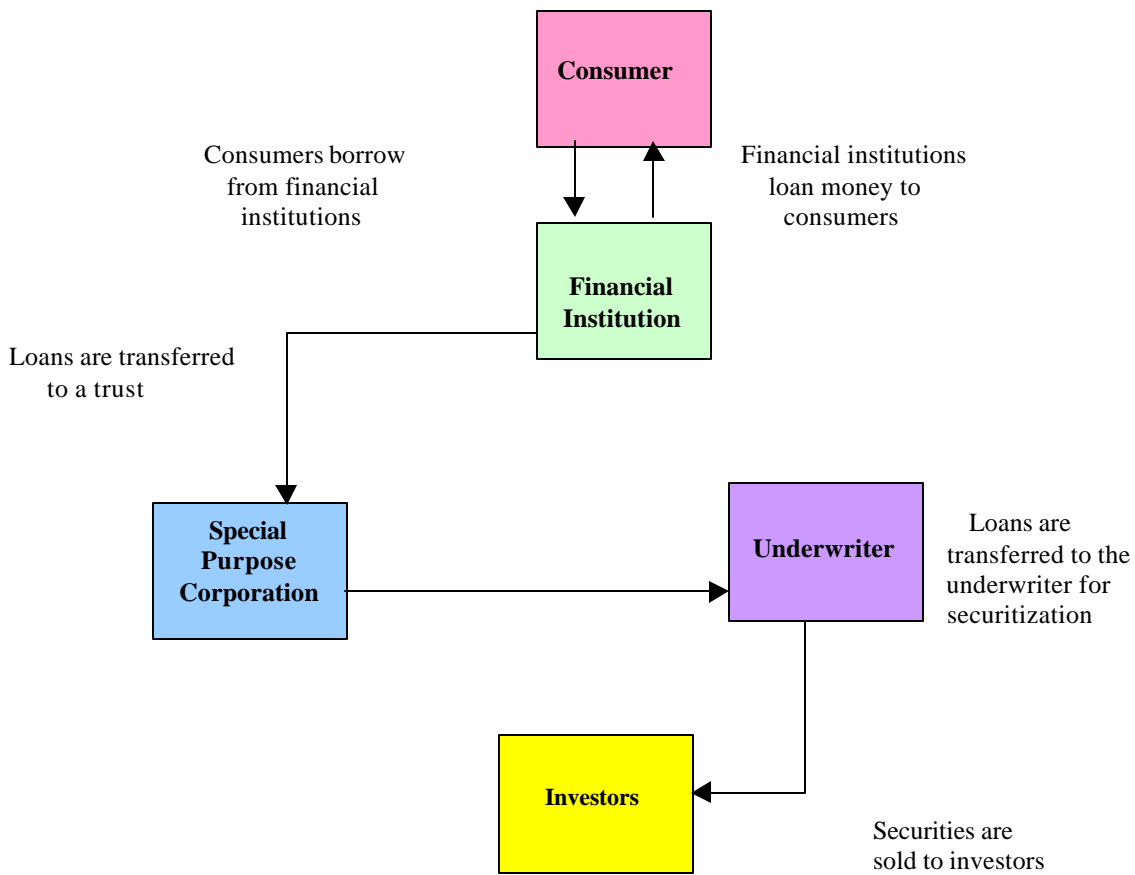
- ensure that daily cash collections forwarded by the servicer to the trustee are invested in eligible investments;
- disburse all cash collections to the appropriate entities;
- determine the appropriate certificate rate for variable rate issues at each repricing date;
- ensure that the seller and the servicer are in compliance with all legal documents governing each transaction; and
- serve as the collateral agent for the benefit of the certificate holders.

The trustee acts in a fiduciary capacity with the preservation of the investors' rights as its primary concern.

The next step is the underwriting process. The underwriter is responsible for advising the seller on how to structure the transaction for pricing and for marketing the security to the investor. The underwriters will package the loans into a securitized instrument and market it to investors. While these main areas comprise the overall structure of the securitization process, there are several intervening roles that are interspersed between these steps. These steps are not necessary to understand the overall concept of the securitization process; therefore, they are not included in this discussion.

The structure of a security and the terms of investors' interests in the collateral can vary considerably. The structure will depend on factors such as the type of collateral supporting the security, the wants and needs of investors, and the use of credit enhancements, both external and internal. Often the securities are structured to re-allocate the risks embodied in the underlying collateral into subparts that match the needs of the investors and the financial institution. A diagram of the overview of the securitization process is detailed in Figure 4.

Figure 4: The Securitization Process



Some of the different roles that are also included in the securitization process are those of servicers and credit enhancers. Each security issue has a servicer who is responsible for collecting the principal and interest payments and for transmitting these funds to either the trust or to the investors. Generally the financial institution that is supplying the loans retains the role of the servicer. This function enables the institution to generate fee income in addition to the other income generated by the securitization process.

Credit Enhancements and Their Role In Protecting Investors Against Losses

A credit enhancement is a method of protecting investors in the event that cash flows from the underlying loans are insufficient to pay the interest and principal due to the investors in a timely manner. Most rating agencies require some form of credit enhancement in order to gain a AAA rating for the security and will dictate specifics regarding the amount necessary to achieve a given rating. Usually, external as well as internal credit enhancements are used to satisfy the requirements for an investment grade rating.

An external credit enhancer in the form of an insuring company may be involved in the process. This is a third party who provides a guarantee for generally a portion of the issue (the amount and conditions under which it will be paid are detailed in the agreements between the involved parties). Their responsibility is to ensure that investors receive their payments in a timely manner, even if the servicer has not collected all the funds from the obligors.

Internal credit enhancements are generally provided by the financial institution as the seller/originator of the issue. Generally, internal credit enhancements are in the first loss position and are retained by the financial institution. This portion is generally referred to as the residual interest. The residual interest is the difference between the stated interest rate on the loans collateralizing the security less the stated interest rate on the security, expenses, and losses. The residual interest represents claims on the cash flows that remain after all obligations to investors and any related expenses have been paid, which normally include funds to build reserves and pay loan losses, servicing fees, and liquidation expenses. The internal credit enhancement provides credit protection by redirecting the internal cash flows. This provides the rationale for the difference in interest rates offered to the investor versus the interest rates charged on the loans. Since the risk of credit loss is borne by the financial institution, the investor should receive a lower rate of return because of the safety of his portion of the investment. The higher risk of loss to the financial institution is rewarded with a potential higher return on investment. Generally, the higher the risk, the higher the potential return. Table 20 illustrates a simplified calculation for excess residual interest.

Table 21: Calculation of Excess Residual Interest

BEGIN WITH:	Gross Interest
LESS:	Pass Through Rate to Investors Delinquency Advances (Net of recoveries) Servicer's Fees Servicing Advances & Liquidation Expenses Reserve Deposits Realized Losses
PLUS:	Prepayment Penalties Collected Interest on Reserves
EQUALS:	Excess or Residual Interest

Source: FDIC's DRR

Recourse provisions are guarantees that require the originator to cover any losses up to a contractually agreed-upon amount. These provisions are usually in the form of a spread account. This is an account that is established with the difference between the interest earned on the assets in the pool and the interest that is paid out to investors. These funds accumulate to an agreed-upon level to protect against losses in the securities. This interest spread is accumulated to repay investors in the event that unexpected losses occur.

Overcollateralization is another form of credit enhancement. This occurs when the value of the underlying assets or collateral exceeds the face value of the security. Because the collateral is worth more than the amount owed to investors, there is a margin of protection against unanticipated losses. Financial institutions can use other methods to originate and accumulate an OC account. Another method of establishing an OC account is discussed in the section on Superior Bank's securitization activities.

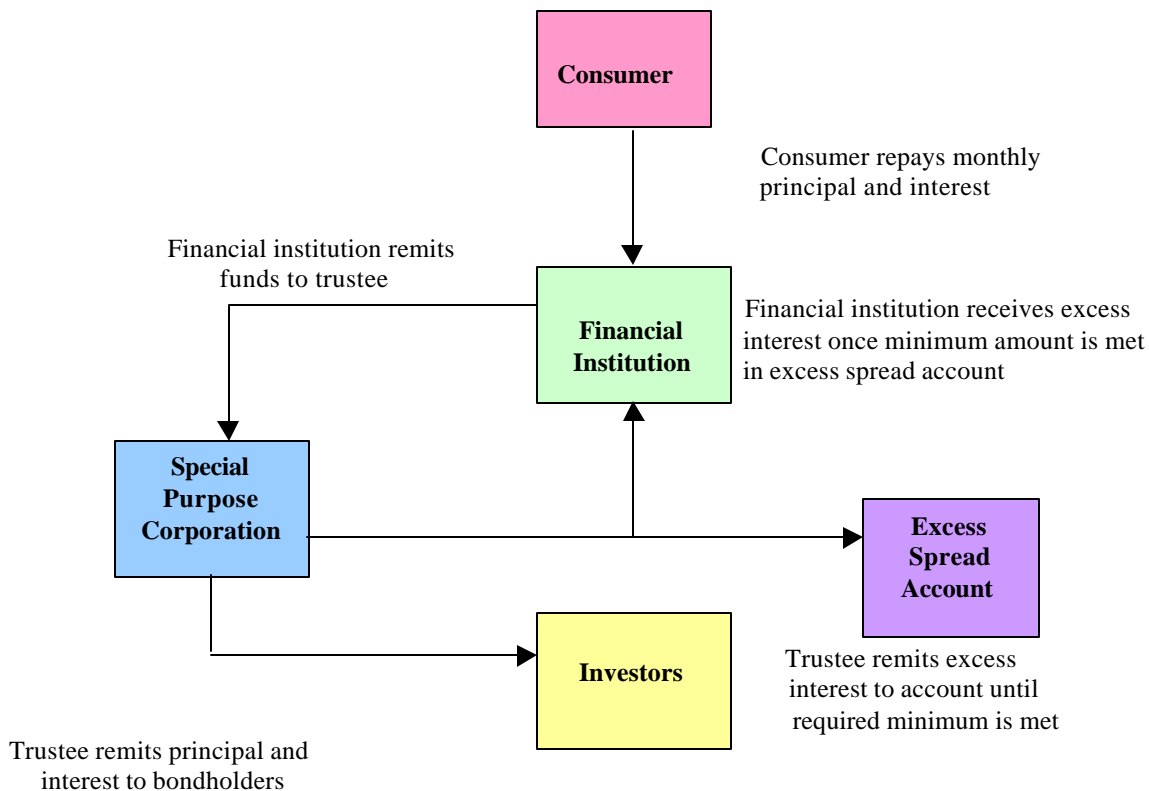
Flow of Funds Through a Securitization

The above sections relate the fundamental elements of how the securitization process is structured. As detailed above, the lending and investment process begins with the consumer borrowing money from the financial institution and ends with the issuance of securities to investors. The money from the investors is then used by the institution to fund more loans.

Now, to fully grasp the entire picture, the repayment of the funds through the securitization process will be discussed. First, the borrower repays the principal and interest on the loan. The servicer, who is generally the financial institution, accumulates the total receipts (which are usually received monthly on residential mortgages and other

consumer loans). The servicer then forwards the specified required amount, which may equal the proceeds received less a servicing fee, to the trustee of the special purpose corporation. The trustee distributes to the investors the principal and interest payments that are due on the securities. If a spread account, such as an OC account, is established, the excess interest is placed in the account until a required minimum level is achieved. The required minimum levels are established by the guaranteeing agency and included in the securitization agreements. The level is generally a percentage of the outstanding balance of the security. Once this required level has been reached, the excess interest is remitted to the financial institution. This flow of funds is detailed in figure 5 below.

Figure 5: Flow of Funds Through the Securitization Process



Accounting for Securitizations

The accounting methodologies used to establish and maintain the values associated with the various components, such as the gain on sale income and credit enhancements, including the OC account and the residual interests, were established in a series of Statements of Financial Accounting Standards (FAS). Until the mid 1990s, accounting principles applicable to securitizations were set forth in FAS 77, *Reporting by Transferors for Transfers of Receivables With Recourse*, and FASB Technical Bulletin 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs) (Tech Bulletin 85-2)*. FAS 77 established the concept of “gain on sale” accounting. Gain on sale accounting requires the recognition of gain or loss if certain criteria for a bona fide sale were met. In

determining the gain on sale, the selling price of the receivable is to be adjusted for such items as the debtor's failure to pay when due, and the estimated effects of prepayments. Tech Bulletin 85-2 provided various criteria as to when gain on sale accounting was appropriate for the types of transactions (collateralized mortgage obligations) to which it applied. FASB subsequently noted that confusion in applying these sets of principles led FASB to reconsider these pronouncements and subsequent guidance. FASB's reconsideration led to the issuance of FAS 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

FAS 125 prescribed the accounting for transfers of financial assets, including securitizations. As such, FAS 125, which became effective for transfers occurring after December 31, 1996, governed securitizations of mortgage and auto loans initiated by Superior since that date. In promulgating FAS 125, FASB recognized that financial assets and liabilities can be divided into a variety of components, for example, servicing rights, residual interests (e.g., residual interests in securitizations), recourse obligations, and pledges of collateral.

Regarding securitizations, FAS 125 prescribes the accounting treatment when (a) a securitization takes place and (b) the transferor (e.g., Superior) presents its financial statements ("subsequent measurement") which indicate the value of the securitizations. When a securitized transaction takes place, the transferor carries on the balance sheet any retained interests, including residual interests and the "beneficial interests" transferred to a qualifying special-purpose entity, such as a trust. In so doing, the transferor allocates its previous carrying values of the assets (e.g., loans) sold and any retained interests, based on their "fair value" at transfer date. "Beneficial interests" are the rights to receive cashflow to a trust, including residual interests.

"Fair value," means a quoted market value for the securities involved, if there is an active market for the securities. If there is no quoted market value, an estimate may be made, based on the best information available. One method for estimating is a present-value analysis of future cash flow using a discount rate commensurate with the risks involved. The analysis should incorporate assumptions that market participants would use regarding:

- future revenues
- future expenses
- interest rates
- default rates
- prepayment
- volatility

"If this method is used, the estimates are to be based on reasonable and supportable assumptions. All evidence is to be considered, with more weight given to evidence that can be verified objectively."

Once the transfer of assets is completed, the transferor records a gain if the cash proceeds of the transaction, net of assets and liabilities incurred (such as interest rate swaps and recourse obligations), that are received by the transferor exceed the allocated book value (as described above) of the assets (e.g., loans) sold. This gain on sale treatment assumes that the transferor has surrendered control over the transferred assets. If control is not surrendered, the transaction must be accounted for as secured borrowing with pledged collateral.

Regarding the second aspect of accounting for securitizations, that is, when the transferor (e.g., Superior) prepares financial statements, the transferor is required to measure residual interests, loan, and other receivables that are subject to prepayment as if they were debt securities, in accordance with FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Accordingly, the transferor must determine the fair value of the interests as of the financial statement (balance sheet) date, with any unrealized gains or losses either recorded in earnings or presented in “other comprehensive income”, depending on whether management considers the securities as trading securities (actively traded and intended for sale in the near term) or as “available for sale”.

FAS 125 was replaced by FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, effective for transactions occurring after March 31, 2001. FAS 140 carried over many of the provisions of FAS 125 but requires, among other things, additional disclosures in the financial statements about securitizations. Because Superior did not engage in any securitizations after March 31, 2001, the provisions of FAS 140 do not apply.