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Audit Report No. 02-024

Marketing and Resolution of Superior Federal, FSB (New Superior)

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Office of Audits
Office of Inspector General

DATE: July 24, 2002

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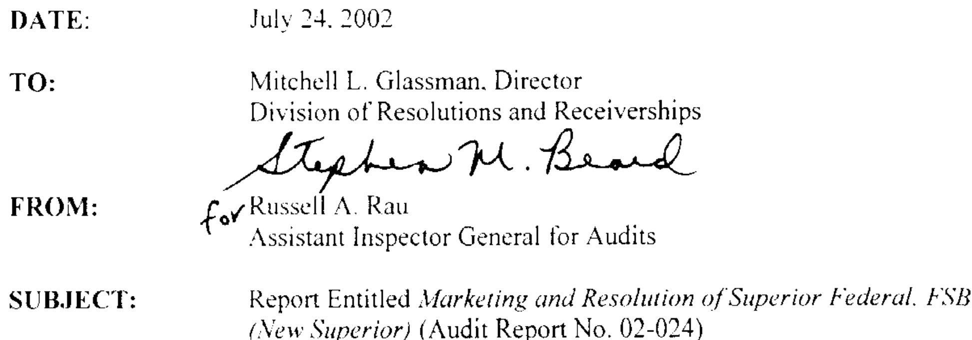
Division of Resolutions and Receiverships



FROM: Russell A. Rau
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SUBJECT: Report Entitled *Marketing and Resolution of Superior Federal, FSB (New Superior)* (Audit Report No. 02-024)

The Office of Inspector General (OIG) conducted an audit of the Federal Deposit Insurance Corporation's (FDIC) marketing and resolution of Superior Federal, FSB, Hinsdale, Illinois. This is the third report issued by the OIG concerning the failure of Superior Bank, FSB.[1] On July 27, 2001, the Office of Thrift Supervision (OTS) closed Superior Bank, FSB, (Superior) and named the FDIC as receiver[2] for the failed institution. Concurrently, the OTS chartered a new institution, Superior Federal, FSB, (New Superior), and appointed the FDIC as conservator[3] to operate the new institution. Just prior to the closing, the FDIC Board approved conservatorship as the least cost[4] strategy for the resolution[5] of Superior, as recommended by the Division of Resolutions and Receiverships (DRR). The FDIC transferred all of the insured deposits[6] totaling $1.5 billion, substantially all of the assets with a book value of $2 billion, and certain other liabilities of Superior with a book value of $300 million to New Superior.

Section 123 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), codified at 12 USC 1811 *et seq.*, requires that the FDIC, as conservator or receiver, sell or dispose of assets in a manner that maximizes the net present value return, minimizes the amount

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[1] The first report, *Issues Related to the Failure of Superior Bank, FSB, Hinsdale, Illinois* (Audit Report Number 02-005), was issued on February 6, 2002 and addressed specific concerns raised by the Chairman, U.S. Senate Committee on Banking, Housing, and Urban Affairs. The second report, *Least Cost Decision of Superior Bank and Liquidation of Remaining Receivership Assets* (Audit Report Number 02-002), was issued on February 8, 2002 and addressed the Division of Resolutions and Receiverships' (DRR) decision to place Superior Bank, FSB (Superior) into conservatorship at the time it was closed by the Office of Thrift Supervision (OTS).

[2] A receiver is an agent appointed by a failed institution's primary federal regulator to manage the orderly liquidation of the failed institution.

[3] A conservator is a person or entity, including a government agency, appointed by a regulatory authority to operate a troubled financial institution in an effort to conserve, manage, and protect the troubled institution's assets until the institution has stabilized or has been closed by the chartering authority.

[4] The FDIC is required under 12 USC 1823(c) to implement the resolution alternative that is determined to be least costly to the relevant deposit insurance fund of all possible resolution alternatives, including liquidation of the failed institution.

[5] Resolution is a disposition plan for a failed or failing institution. It is designed to (1) protect insured depositors and (2) minimize the costs to the relevant insurance fund.

[6] A deposit balance is a liability of the financial institution, representing the depositor's right to receive an equivalent sum of money from the bank. The terms insured deposit, deposit liability, and deposit franchise are used interchangeably throughout the report.

of any loss realized in the resolution, ensures adequate competition and fair treatment of offerors, and prohibits discrimination in the solicitation and consideration of offerors. Section 123 also requires the FDIC to maximize the preservation of the availability and affordability of residential real property for low- and moderate-income individuals. Because we did not review the sales of residential real property, this provision did not apply to this audit. Appendix I presents the specific FDICIA requirements of Section 123.

The objectives of this audit were to evaluate: (1) the marketing efforts for the assets and principal product groups of New Superior and (2) the resolution of New Superior conservatorship in accordance with the least cost strategy. Specifically, we assessed whether the marketing efforts complied with established DRR policies and procedures and with applicable laws. We also used information obtained during our fieldwork to compare the most recent loss estimate for the resolution of New Superior to that estimated in the least cost test performed in July 2001. Additionally, we followed the status of the assets in the receivership and the progress made on resolving them.

Appendix II of this report includes additional information on the scope of this audit and the methodology used to answer the objectives. Appendix III of this report is a glossary of terms that are used throughout the report. Appendixes IV through VI provide more detailed discussion of specific parts of the audit.

BACKGROUND

In response to numerous financial institution failures from the mid-1980s through the early 1990s, the Congress passed FDICIA, codified at 12 USC 1811 *et seq*., to ensure the stability of the financial banking sector and the deposit insurance funds. Section 123 of FDICIA requires that the FDIC, as conservator or receiver, sell or dispose of assets in a manner that maximizes the net present value return, minimizes the amount of any loss realized in the resolution, ensures adequate competition and fair treatment of offerors, and prohibits discrimination in the solicitation and consideration of offerors. Section 131 of FDICIA, codified at 12 USC 1831o, incorporated provisions for Prompt Corrective Action (PCA). The PCA provisions of FDICIA establish minimum capital requirements that assist the primary federal regulator in the regulation of financial institutions.[7] PCA provisions require more timely intervention by the primary federal regulator to minimize losses to the deposit insurance funds. PCA requires that the primary federal regulator close an institution within 90 days after determining that the institution is "critically undercapitalized" and does not have an adequate capital restoration plan. (See

[7] Primary federal regulators are listed in the following table:

Agency	Type of Institution Regulated
FDIC	State non-member banks and state savings banks insured by BIF
Office of the Comptroller of the Currency (OCC)	National banks
Federal Reserve Board (FRB)	Bank holding companies and state member banks
Office of Thrift Supervision (OTS)	Federal and state savings associations insured by SAIF and thrift holding companies

Appendix I) In order to accomplish the objectives of these statutory provisions, DRR seeks prompt and sufficient access to a failing institution in order to reduce or eliminate losses to the insurance funds.

DRR's mission is to plan and efficiently handle the resolutions of failing FDIC-insured institutions and to provide prompt, responsive, and efficient administration of failing and failed FDIC-insured institutions in order to maintain confidence and stability in the national financial system.[8] DRR's resolution planning activities may occur simultaneously with the primary federal regulator's efforts to restore an institution to financial health. OIG analysis in a previous report entitled, *Least Cost Decision of Superior Bank and Liquidation of Remaining Receivership Assets* showed that from January 2000 to October 2001, 12 of 22 institutions for which DRR performed on-site resolution activity did not subsequently fail. DRR is proactive in identifying troubled insured depository institutions, and DRR may begin its resolution efforts, such as valuing assets and identifying potential purchasers of these institutions, before an institution fails.

Although PCA does not provide for the resolution process to begin until an institution is notified by the primary federal regulator that it is critically undercapitalized, DRR and the FDIC's Division of Supervision[9] (DOS) have recognized that in some cases a failing institution may necessitate closure on an expedited basis. To that end, formal procedures have been established by FDIC directive for the collection and sharing of information between DRR and DOS for FDIC-insured institutions that appear likely to fail before the primary federal regulator notifies the institution that it is critically undercapitalized. These formal procedures include provisions that DOS staff seek the failing institution's consent to allow DRR access to the institution and its records to facilitate the resolution process of a failing institution. DRR has established a similar information sharing arrangement with the OCC. DRR does not have a formal information sharing arrangement with the OTS. On April 26, 2002, DRR sought assistance from the FDIC Chairman in initiating a series of meetings with the other primary federal regulators with the goal of developing an interagency Memorandum of Understanding (MOU). This MOU would allow DRR staff to have earlier and broader access to problem institutions in order to develop contingency plans in the event of a failure.

During the spring of 2001, OTS and the FDIC were working with Superior's owners on a plan to recapitalize the institution (capital restoration plan). OTS approved the capital restoration plan on May 24, 2001, and Superior's owners were required to implement the plan no later than July 23, 2001.[10] Because OTS, Superior's primary federal regulator, had not determined that the institution was critically undercapitalized and there was an approved capital restoration plan in effect, there were no provisions under PCA for DRR to begin formal resolution procedures. However, OTS allowed preliminary resolution work to start onsite. Superior's owners failed to implement the capital restoration plan on schedule, and on July 24, 2001, OTS notified Superior

[8] The FDIC insures the deposits of financial institutions and is responsible for resolving all failed institutions, regardless of the failed institution's chartering authority.
[9] As the result of a reorganization that became effective June 30, 2002, this office was merged with the Division of Compliance and Consumer Affairs to become the Division of Supervision and Consumer Protection (DSC).
[10] Although the FDIC expressed concern over several aspects of the capital restoration plan and conveyed these concerns to OTS prior to OTS's approval of the plan, the FDIC did not object to the OTS's approval of the final plan.

that the institution was critically undercapitalized.

On July 25, 2001, DRR presented its Failing Bank Case to the FDIC Board of Directors. This case recommended that once OTS closed Superior, the Board approve a pass-through receivership transaction[11] and accept appointment as receiver and conservator as the least cost resolution decision. It was DRR's position in the Failing Bank Case that the conservatorship approach provided DRR the necessary time to preserve the value of and market competitively the deposit liabilities and assets of New Superior. The Board approved the case, and on July 27, 2001, OTS chartered New Superior and appointed the FDIC as conservator. As authorized in the Board resolution, the conservator hired a Chief Executive Officer (CEO) to run the conservatorship operations. In addition, the conservator hired a financial advisor to assist in the valuation and marketing of the assets of the conservatorship.

As of the date of failure, New Superior had approximately $1.5 billion of insured deposits at 18 branch offices. The FDIC DRR Franchise Marketing Branch marketed the deposit liabilities and associated assets, including the branch facilities and an insurance subsidiary.[12] In addition, the FDIC sought to preserve value by ensuring that New Superior's loan origination operations headquartered in Orangeburg, New York, were not disrupted. The FDIC viewed disruption of these operations as a risk to maintaining the value of the residual interest assets[13] that were also managed in Orangeburg. DRR, with assistance from New Superior personnel and third-party contractors, sold other assets of the conservatorship. The conservatorship had assets with a book value of $2 billion from which we reviewed a sample of $1.3 billion that included securities, automobile loans, and other performing and subperforming loans.

On December 10, 2001, the FDIC and the OTS announced a settlement agreement with the previous owners of Superior. The settlement agreement covered all matters arising out of the operation and failure of Superior. Under the terms of the agreement, Superior's previous owners agreed to pay $100 million in cash and signed a promissory note for the remaining $360 million to be paid over 15 years at no interest. The settlement monies will offset some of the eventual loss to the Savings Association Insurance Fund (SAIF), which as of May 14, 2002 is estimated at $763 million.[14] The net loss to the SAIF after considering the present value of the settlement amount is $440 million. The loss also includes the actual and projected recoveries and losses on the assets and liabilities of the conservatorship and the receivership. The FDIC Division of

[11] A pass-through receivership is when all deposits, substantially all of the assets, and certain nondeposit liabilities of the original institution instantly "pass through the receiver" to a newly chartered federal mutual association, subsequently known as the "conservatorship." In the case of Superior, the FDIC is the receiver of the assets and liabilities that did not transfer to New Superior, the conservatorship.

[12] DRR sold as a package the deposits, some cash and cash equivalent accounts, branches of New Superior, and Superior Insurance and Financial Services, Inc. In addition, the conservator passed to the acquirer of the deposits the Home Equity Line of Credit (HELOC) loans. DRR marketed this package of deposits and assets using a secured Web site to disseminate financial and descriptive information.

[13] These interests represent claims on the cash flows resulting from the securitization process 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. When the loans for the pools originate, they bear a stated interest rate. The securities are issued to the investors at a lower rate than the stated rate on the loans. The difference between the rate that the loans are paying and what the pools are paying to investors is called the residual.

[14] The SAIF is the insurance fund affected by the failure of Superior.

Finance updates the projected loss as new information is received by DRR. The final loss to the SAIF cannot be determined until all assets and liabilities are dispositioned. DRR terminated the conservatorship and transferred all remaining assets and liabilities to the initial receivership as of May 31, 2002.

The $182.6 million in assets transferred to the receivership at the time of closing of Superior primarily remain in the receivership at this time. The most significant change to the balance in the receivership prior to the termination of the conservatorship was the write-off of a $37.2 million account receivable from Superior's holding company as a result of the settlement agreement. A bond claim for $3.5 million was added to the receivership to recover losses from the actions of the failed institution.

RESULTS OF AUDIT

DRR effectively marketed Superior's deposit liabilities and assets to maximize the return to the conservatorship. In all sales we reviewed, except for one security sale, DRR awarded the sales to the highest bidders. We were unable to determine if DRR selected the highest bidder for the one security sale, because of insufficiencies in the sale file documentation. We also noted other instances where documentation required by DRR's policies and procedures was missing from the securities sales files. Maintaining complete sales files provides assurance that the FDIC fulfills its obligation to maximize the return, minimize the loss, ensure adequate competition and fair treatment of offerors, and prohibit discrimination in the solicitation and consideration of offerors as required by Section 123 of FDICIA. The FDIC, as conservator, used contractors to assist in the marketing of Superior's liabilities and assets. Fintek, Inc. (Fintek), an affiliate of Superior, was retained by the conservator to assist in the marketing of securities. We reviewed payments made to Fintek by the conservator to determine if the payments were allowable under the terms of the contract. We identified $28,043 in overpayments made by the conservator to Fintek. Appendix IV contains more information about DRR's effective marketing.

At the time of the failure, DRR recommended conservatorship as the least cost strategy for the resolution of Superior based on the limited information available at that time. As discussed in our audit report entitled, *Least Cost Decision of Superior Bank and Liquidation of Remaining Receivership Assets*, DRR's access to Superior's records and personnel prior to the failure was limited, partly based on the fact that Superior's owners were in the process of implementing a capital restoration plan approved by the primary federal regulator intended to address the capital problems. The failure of Superior's ownership to implement the approved capital restoration plan severely limited the time available to consider other resolution strategies and was a major reason that DRR did not complete key documentation[15] supporting the recommended resolution approach. Conservatorship gave DRR the time to develop information on the assets and deposit liabilities of Superior and to market them effectively. By selecting the best bid for each asset sale conducted, as well as the deposit liabilities sale, DRR has resolved the Superior

[15] DRR was unable to complete the Information Package and the Asset Valuation Review, two critical activities that enable DRR to solicit bids from potential acquirers and compare the offers for determining the least costly resolution. See Glossary for definitions of Information Package and Asset Valuation Review.

conservatorship in accordance with the least cost strategy selected at the time of the failure. If DRR is successful in its efforts to establish MOUs with the other primary federal regulators and gain earlier and broader access to failing institutions, then future resolution decisions can be made with the best information available. In the case of Superior, earlier and broader access to more current information may have improved DRR's estimates of the potential loss from the failure and its decision-making on continuing the loan origination operation in Orangeburg, New York.

Additional access to the failing Superior would have provided DRR with more complete information upon which to base its decisions about the proper resolution of Superior. If DRR had been positioned to thoroughly review Superior's records and operations prior to failure, DRR would have had better information on which to estimate the loss and better information to use in decision-making. Over the life of the conservatorship, the estimated loss to the SAIF has increased from $550 million to $763 million, exclusive of the settlement with the owners of Superior. This increase is primarily attributable to an increased loss on the sale of the residual interest assets and a smaller premium received on the sale of the deposit liabilities. Both of these estimates may have been improved by better access to the institution prior to failure. (See Appendix V for a more detailed discussion.)

With better information, DRR also may have been able to avoid certain costs related to continuing the loan origination operation in Orangeburg, New York. Because of the limited information available at the time of the failure, the FDIC decided to continue operating the loan origination activities at Orangeburg until a value could be assigned to the asset. While the FDIC was able to sell the loan inventory created, the loan origination activities were expensive to operate and in the end were not attractive to buyers and could not be sold. The costs of operating the loan origination activities, along with the severance and retention bonus payments made to loan origination employees who lost their jobs, increased the loss to the SAIF associated with the failure of Superior. These additional expenses could be as much as $11 million. (See Appendix VI for additional details.)

We have already addressed the need for DRR to have earlier access to failing institutions in our previous audit report on the *Least Cost Decision of Superior Bank and Liquidation of Remaining Receivership Assets*. Because DRR is seeking MOUs with the other primary federal regulators, we are not making additional recommendations regarding access at this time.

We also tracked DRR's progress to liquidate the assets transferred to the receivership at the time of closing of Superior. Currently $152.3 of $182.6 million in assets transferred at closing remains in the receivership.

DOCUMENTATION OF SECURITIES SALES COULD BE IMPROVED

Transaction files of securities sales did not contain all the support required to document the completeness of the sales process. In particular, documentation of bidders solicited and security valuations were missing from most files reviewed. We were able to determine in all but one case that the highest bidder was selected. However, in future sales, DRR needs to ensure that there is

complete documentation of all securities sales. Maintaining complete sales files provides assurance that the FDIC fulfills its obligation to maximize the return, minimize the loss, ensure adequate competition and fair treatment of offerors, and prohibit discrimination in the solicitation and consideration of offerors as required by Section 123 of FDICIA.

In April 1996, the Division of Depositor and Asset Services, a precursor of DRR, issued the *Office of Securities Transactions Procedures Manual*. This manual documented the policies and procedures for the sale of securities and related capital markets instruments by the Office of Securities Transactions. The transmittal letter stated that the manual would supercede the *Asset Disposition Manual* for sales of securities. This was the most current guidance that DRR was able to provide for how securities sales were to be documented and conducted.

According to the *Office of Securities Transactions Procedures Manual*, DRR markets securities to selected qualified bidders included in DRR's database of bidders and typically sells the securities by auction. DRR's database includes information about the type of securities that the bidder is interested in purchasing. Other securities buyers may contact the FDIC to express an interest in purchasing securities and submit financial information to be assessed as qualified. DRR also reviews the securities sales files for winning and second place bidders of previously sold securities similar to those being offered for sale. DRR uses this information to select between 5 and 15 potential bidders, depending on the type of security offered for sale. Once the bidders are selected and approved, a notification of auction or a Dealer Bid Sheet is sent to each bidder. The Dealer Bid Sheet includes information about the security being offered, including bid instructions. DRR establishes a minimum sales price for each security that DRR will accept based on various market conditions. After the bids are received, DRR prepares a bid summary that includes all the bids received during the auction. If the bids received equal or exceed DRR's valuation amount, the highest bidder is awarded the security and the winning bid is denoted on the bid summary. If DRR does not receive a bid that equals or exceeds DRR's valuation amount, DRR conducts another auction of the security at a later date, or seeks additional approval to accept the best offer after careful consideration of market conditions.

Our sample included $27.8 million of securities sold from $122 million in total securities sales as of January 4, 2002. This sample represented one security from each of the six sales conducted during the period. Both DRR employees and the third-party contractor, Fintek, who assisted with the sales, maintained the files documenting the sales of securities that were on the books of Superior at the time of failure. All but one of our sampled files indicated that the security was sold to the bidder offering the sales price that was the best value to the conservatorship. For the other file, there was no bid summary sheet in the file, so it was not possible to determine whether the highest bid had been accepted.

According to the *Office of Securities Transactions Procedures Manual*, the files documenting the sales of securities should include, among other items:

- Auction Notification Letter (or Dealer Bid Sheet),
- Market data to substantiate the sales price, and
- Completed bid summary.

Table 1: Review of Securities Sales Files

Security Number	Sale Date	Dealer Bid Sheet	Documentation of Bidders Solicited	Documentation of Valuation	Bid Summary Sheet	Number of Bidders
RFMSI 1993-S47-A-23	08/23/2001	Y	N	N	Y	9
GECMS 1996-14 A8	10/04/2001	Y	N	N	Y	10
GT 1998-4 A5	10/15/2001	Y	N	N	Y	7
FHR 2177 CA	10/18/2001	N*	N	Y	Y	11
CMSI 1996-1 M	10/25/2001	Y	Y	Y	Y	9
GECMS 1993-17 A11	11/08/2001	Y	Y	N	N	Not available

Source: OIG Analysis of DRR files * Only one security offered

As shown in the above table, there were weaknesses in the files for documentation of bidders and valuations of securities offered for sale. The weaknesses in the valuation documentation were partially mitigated when the bid summary sheet was available to ensure that the highest bid was accepted on the sales transaction. In addition, the bid summary sheet presented the number of bidders and their bids. Because there were several bids received for each security, the sales price indicated the security sold at a market value. However, the required documentation needs to be prepared at each step of the process, rather than at the end, to ensure bids are appropriately solicited from qualified bidders and securities are properly valued before selection takes place. From a review of DRR's database of bidders, we determined that the winning bidders were approved bidders, even though neither DRR nor the contractor documented how the bidders were selected.

According to the minutes of the August 16, 2001 New Superior Board of Directors meeting, the Board wanted DRR employees to supervise Fintek closely during the conduct of these securities sales to ensure a competitive sales process was conducted and documented. Therefore, DRR should have ensured that the requirements of the *Office of Securities Transactions Procedures Manual* were completed as part of DRR's oversight responsibilities. At a minimum, DRR should have ensured that the following information was formally documented in the files:

- Support for bidder selection and notification to bidders of sales to ensure adequate competition and fair treatment of bidders and to prohibit discrimination in the solicitation and consideration of bidders;
- Valuations conducted prior to the sale to ensure that the FDIC maximizes the recovery and minimizes the loss to the SAIF by selling at true market prices; and
- Bid Summary Sheets to document adequate competition and the appropriateness of the selections of winning bidders.

RECOMMENDATION

We recommend that the Assistant Director, Franchise and Asset Marketing Branch, DRR:

(1) ensure that securities sales transactions are valued and documented in accordance with the requirements of the *Office of Securities Transactions Procedures Manual*.

BILLING ERRORS ASSOCIATED WITH CONTRACT WITH FINTEK

Fintek was overpaid $28,043 for professional fees and out-of-pocket expenses under its contract to assist in the sales of securities on the books of Superior at the time of failure. Professional fees of $3,741 were overbilled because of an undetected error in the supporting documentation, and out-of-pocket expenses of $24,302 were submitted contrary to contractual requirements and erroneously approved for payment by conservatorship personnel.

At the time of failure, Fintek, an affiliate of Superior, was providing investment management advisory services to the institution. Despite this relationship with the failed institution, the FDIC Legal Division agreed that the conservator could continue the relationship with Fintek under similar contractual requirements. From July 27, 2001 through September 30, 2001, the contract between New Superior and Fintek required Fintek to submit invoices showing the hours worked and the discounted hourly rate for each employee providing services to the conservatorship. In addition, Fintek was to be reimbursed for documented out-of-pocket expenses. During this period, Fintek was paid $571,631 in professional fees. The spreadsheet submitted in support of the billing for the period August 16, 2001 through August 31, 2001 contained an error, and the conservator directed Fintek to resubmit both that period's timesheet and the previous period's timesheet. However, the resubmitted amounts still did not agree to the support and we identified an overpayment of $3,741. We determined that the out-of-pocket expenses submitted for the period were allowable under the terms of the contract.

On October 24, 2001, by mutual consent of the parties, the contract was modified to provide for a flat monthly fee of $250,000 for the period October 1, 2001 through December 31, 2001 (the interim contract period). This amount was to be paid semi-monthly upon presentation of an accurate invoice. This agreement was a flat monthly fee contract that did not allow for Fintek to be reimbursed for out-of-pocket expenses in excess of the $250,000 flat monthly fee. However, an employee of DRR working for the conservatorship directed that out-of-pocket expenses be reimbursed, as that was the intent of the contract according to the President and CEO of New Superior. According to the draft Board minutes of New Superior, the Board determined that a flat monthly fee contract would cover all of Fintek's expenses and could even provide funds to establish a severance plan for its employees. We concluded that the conservatorship overpaid Fintek by $24,302 in out-of-pocket expenses, because the payment of these expenses was in addition to the $250,000 flat monthly fee. Fintek incurred these out-of-pocket expenses during the interim contract period.

In mid-December, when the conservator recognized that Fintek's services would be needed after December 31, 2001, a case was prepared and presented to the New Superior Board of Directors

requesting that a maximum of $250,000 be authorized for an extension of Fintek's services through March 31, 2002. The Chairman of the New Superior Board of Directors approved this extension on January 10, 2002. All amounts paid under this contract extension through February 12, 2002 were in compliance with the terms.

To summarize, over the period July 27, 2001 through February 12, 2002, Fintek received $1,398,521 in professional fees and $32,273 in reimbursed expenses for a total of $1,430,794. Of this amount, we question $3,741 in professional fees and $24,302 in reimbursed expenses for a total of $28,043, or 2 percent of the funds received. These questioned costs were discussed with DRR management who agreed to determine the possibility of offsetting Fintek's current billing in order to recover these amounts.

RECOMMENDATIONS

We recommend that the Assistant Director, Franchise and Asset Marketing Branch, DRR, in his capacity as the Chairman, New Superior Board of Directors:

(2) disallow the $28,043 in questioned professional fees and reimbursed expenses paid to Fintek and seek reimbursement from the company to the conservatorship.

(3) review billings submitted by Fintek since February 12, 2002 and ensure that all payments comply with the terms of the contractual agreement.

STATUS OF RECEIVERSHIP ASSETS

At closing, the pass-through receivership retained $182.6 million in assets from the failed institution. As of May 13, 2002, there was $152.3 million in assets in the Superior receivership. The primary activity in the account was the write-off of a $37.2 million receivable from one of Superior's holding companies that was written off as part of the settlement agreement. In addition, a $3.5 million bond claim was added to the receivership, along with $3.4 million in miscellaneous transfers between the conservatorship and receivership and adjustments to the balances as a result of ongoing operations. From a review of DRR's Credit Notation System, an asset management system, we determined that DRR is continuing its determination of the viability of recoveries by the receivership.

CORPORATION COMMENTS AND OIG EVALUATION

On July 15, 2002, the Director of DRR provided a written response to the draft report. The response is presented in Appendix VII to this report. We also had subsequent discussions with the Assistant Director, Marketing Section, DRR and the Assistant Director, Internal Review, DRR to clarify the Division's response.

The Corporation agreed with all recommendations. DRR will take steps to ensure that, in the future, documentation of how the list of potential bidders was compiled, notification to bidders of sales, valuations, and bid summary sheets are maintained. Additionally, DRR will consult with the Legal Division (Legal) to determine if there is a reasonable chance of collecting the $28,043 in expenses paid to Fintek. DRR plans to request Legal's determination by July 26, 2002. Finally, by September 30, 2002, DRR will re-review billings subsequent to February 12, 2002. The recommendations are resolved but remain undispositioned and open for reporting purposes until we have determined that agreed-to corrective actions have been completed and are effective.

FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT OF 1991 FDIC PROPERTY DISPOSITION STANDARDS AND PROMPT CORRECTIVE ACTION

Section 123 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) discusses the standards required in the disposition of assets. Relevant excerpts from Section 123 are found below:

> (E) DISPOSITION OF ASSETS. – In exercising any right, power, privilege, or authority as conservator or receiver in connection with any sale or disposition of assets of any insured depository institution for which the Corporation has been appointed conservator or receiver, including any sale or disposition of assets acquired by the Corporation under section 13(d)(1), the Corporation shall conduct its operations in a manner which—
>
> (i) maximizes the net present value return from the sale or disposition of such assets;
> (ii) minimizes the amount of any loss realized in the resolution of cases;
> (iii) ensures adequate competition and fair and consistent treatment of offerors;
> (iv) prohibits discrimination on the basis of race, sex, or ethnic groups in the solicitation and consideration of offerors; and
> (v) maximizes the preservation of the availability and affordability of residential real property for low- and moderate-income individuals.

Section 38 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires prompt corrective action to protect the deposit insurance funds. Relevant excerpts from Section 38 are found below:

(a) RESOLVING PROBLEMS TO PROTECT DEPOSIT INSURANCE FUNDS.-

(1) PURPOSE.-The purpose of this section is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund.

(2) PROMPT CORRECTIVE ACTION REQUIRED.-Each appropriate Federal banking agency and the Corporation (acting in the Corporation's capacity as the insurer of depository institutions under this Act) shall carry out the purpose of this section by taking prompt corrective action to resolve the problems of insured depository institutions.

(b) DEFINITIONS.-For purposes of this section:

(1) CAPITAL CATEGORIES.-

(A) WELL CAPITALIZED.-An insured depository institution is "well capitalized" if it significantly exceeds the required minimum level for each relevant capital measure.

(B) ADEQUATELY CAPITALIZED.-An insured depository institution is "adequately capitalized" if it meets the required minimum level for each relevant capital measure.

(C) UNDERCAPITALIZED.-An insured depository institution is "undercapitalized" if it fails to meet the required minimum level for any relevant capital measure.

(D) SIGNIFICANTLY UNDERCAPITALIZED.-An insured depository institution is "significantly undercapitalized" if it is significantly below the required minimum level for any relevant capital measure.

(E) CRITICALLY UNDERCAPITALIZED.-An insured depository institution is "critically undercapitalized" if it fails to meet any level specified under subsection (c)(3)(A).

(c) CAPITAL STANDARDS.-

(3) CRITICAL CAPITAL.-

(A) AGENCY TO SPECIFY LEVEL.-

(i) LEVERAGE LIMIT.-Each appropriate Federal banking agency shall, by regulation, in consultation with the Corporation, specify the ratio of tangible equity to total assets at which an insured depository institution is critically undercapitalized.

(ii) OTHER RELEVANT CAPITAL MEASURES.-The agency may, by regulation, specify for 1 or more other relevant capital measures, the level at which an insured depository institution is critically undercapitalized.

(h) PROVISIONS APPLICABLE TO CRITICALLY UNDERCAPITALIZED INSTITUTIONS.-

(3) CONSERVATORSHIP, RECEIVERSHIP, OR OTHER ACTION REQUIRED.-

(A) IN GENERAL.-The appropriate Federal banking agency shall, not later than 90 days after an insured depository institution becomes critically undercapitalized-

(i) appoint a receiver (or, with the concurrence of the Corporation, a conservator) for the institution; or

(ii) take such other action as the agency determines, with the concurrence of the Corporation, would better achieve the purpose of this section, after documenting why the action would better achieve that purpose.

SCOPE AND METHODOLOGY

Scope

Our work included the evaluation of the DRR's marketing efforts for the assets and principal product groups of Superior Federal, FSB (New Superior). OTS appointed the FDIC as conservator of New Superior on July 27, 2001. The FDIC, as conservator, was responsible for the liquidation of New Superior assets and liabilities totaling over $2 billion that had not been transferred to the receivership. Our work also included an attempt to evaluate the resolution of the New Superior conservatorship in accordance with the least cost test strategy. Because DRR is not required to perform the least cost test for the resolution of the conservatorship, we used information obtained during our fieldwork to compare the most recent loss estimate for the resolution of New Superior to that estimated in the least cost test performed in July 2001. Our scope did not include loans held for sale by either Superior Bank, FSB (Superior) or New Superior. Our scope also did not include the settlement of the proceeds received from the sale of the deposits or assets.

To achieve the audit objective regarding the evaluation of the marketing efforts, we relied on computer-processed data produced by the optimization software, *What's Best!* We assessed the reliability of these data by tracing bid information to the source documents. Nothing came to our attention as a result of specified audit procedures that caused us to doubt the reliability of the computer-processed data. During an earlier audit, as reported in *Audit of the Least Cost Test Model* (Audit Report Number 01-025, issued December 13, 2001), we tested the reliability of the *What's Best* software and found that it operated as designed in selecting the winning bid. Therefore, no additional tests were considered necessary.

Methodology

To evaluate DRR's marketing of New Superior's assets, we:

- reviewed DRR's *Asset Disposition Manual*, *Resolution Policy Manual*, *Office of Securities Transactions Procedures Manual,* Franchise Marketing Job Aides, and *Standard Asset Value Estimation Instruction Manual*;
- randomly selected one security sale from each of the six securities sales that DRR conducted during the period July 27, 2001 through January 4, 2002, representing $27.8 million of $122 million in securities sold and assessed compliance with DRR's policies and procedures;
- reviewed all 18 asset pool sales that DRR conducted for the disposition of the automobile loan portfolio and a portfolio consisting of loans that have prior delinquencies and/or had fallen out of previous sale attempts by Superior (Scratch and Dent I), representing $81.1 million in book value and $77 million in book value, respectively, and assessed compliance with DRR's policies and procedures;

- reviewed DRR's sales of all operations from the Orangeburg, New York, location and assessed compliance with DRR's policies and procedures;
- evaluated DRR's sale of the deposit franchise to Charter One;
- interviewed DRR personnel in both Washington, DC, and Dallas, Texas, as well as contractor personnel responsible for the marketing of New Superior's assets;
- reviewed Franchise and Asset Marketing files;
- obtained access to FDIC and third-party Web sites used during the marketing of assets;
- reviewed cases submitted and approved by the New Superior Board of Directors for the sales of assets;
- reviewed the draft minutes of meetings of the New Superior Board of Directors;
- reviewed third-party valuations of the assets sold when available;
- verified that the payments made by the conservatorship to an affiliated third party of Superior, Fintek, Inc., from July 27, 2001 through February 12, 2002 were allowable under the terms of the contracts covering the period of July 27, 2001 through March 31, 2002; and
- evaluated the bids received and the selling price for each asset sale reviewed.

To compare the most recent loss estimate to the loss estimate at the time of failure, we:
- determined the effect of asset and deposit liability sales on the loss estimate,
- reviewed the terms of the settlement agreement with the owners of Superior to establish its effect on the loss estimate,
- reviewed FDIC press releases and transcripts from FDIC Board of Directors meetings for discussion related to settlement negotiations and loss estimate projections,
- obtained information from the FDIC Division of Finance on the most recent reserves established for the estimated loss associated with the failure of Superior, and
- traced significant variances between the Least Cost Test and the ultimate resolution of particular assets and deposit liabilities.

We also reviewed the status of assets in the receivership by accessing DRR's Credit Notation System and contacting receivership personnel.

We performed our work at the FDIC's offices in Washington, DC, and Dallas, Texas, from October 31, 2001 through May 10, 2002. In addition, we visited HanoverTrade.com, located in Edison, New Jersey, on March 15, 2002 to review the valuation of the Orangeburg, New York assets and the bidding process. HanoverTrade.com was the financial services advisor hired by the conservatorship to assist with the sales of the Orangeburg assets. We conducted the audit in accordance with generally accepted government auditing standards.

APPENDIX III

GLOSSARY

Asset Valuation Review (AVR)
Process that estimates the value of assets to the Federal Deposit Insurance Corporation (FDIC) as Receiver of the failing institution. The AVR compares the book value of assets to the estimated recovery values (ERV) to help determine the projected net loss to the FDIC.

Conservatorship
A legal procedure and resolution strategy available to the FDIC, under authority provided by FIRREA, for the interim management of financial institutions. Under the pass-through receivership method, after the failure of a savings institution, a new institution is chartered and placed under agency conservatorship; the new institution assumes certain liabilities and purchases certain assets from the receiver of the failed institution. Under a straight conservatorship, the FDIC may be appointed conservator of an open, troubled institution. The conservator assumes responsibility for operating the institution on an interim basis in accordance with applicable laws of the federal or state authority that chartered the new institution. Under a conservatorship, the institution's asset base is conserved pending the resolution of the conservatorship. See 12 USC 1831o(h).

Deposit Premium
The amount a bidder is willing to pay above the value of an institution's insured deposits.

Information Package (IP)
The Information Package provides a description, in financial terms, of the failing institution's assets, liabilities, and business on a specific date with supporting schedules. This product, developed by DRR's Franchise Marketing Branch, is used as a marketing tool to help potential acquirers decide if they are interested in a transaction with the FDIC to resolve a failing institution.

Least Cost Resolution
A determination required under 12 USC 1823(c) for the FDIC to implement the resolution alternative that is determined to be least costly to the relevant deposit insurance fund of all possible resolution alternatives, including liquidation of the failed institution.

Liquidation
The winding down of the business affairs and operations of a failed insured depository institution through the orderly disposition of its assets after it has been placed in receivership.

Office of Thrift Supervision (OTS)
The office within the U.S. Department of the Treasury that has responsibility for the overall supervision, regulation, and examination of federally chartered thrift institutions.

Receivership
The legal procedure for winding down the affairs of an insolvent institution. See 12 USC 1831o(h).

EFFECTIVE MARKETING OF CONSERVATORSHIP ASSETS AND DEPOSIT LIABILITIES

We selected approximately 65 percent of the book value of assets in the conservatorship and reviewed the sales, including: 18 bulk loan pools of residential mortgage loans and auto loans, and the residual interest assets associated with securitizations, securitization servicing rights, and securities. We also reviewed the sale of the deposits. We determined that DRR sold the deposits and certain assets to bidders in sales that maximized the value of the conservatorship. Each asset and liability reviewed is discussed below, except for the sales of securities, which are discussed in the body of this report.

Bulk Loan Sales Complied with Established Policies

Each of the 18 asset pool sales conducted by DRR for assets that transferred to New Superior complied with established DRR policies and procedures and resulted in sales at the best price to the conservatorship. One group of 10 asset pools sold for $64 million and another group of 8 pools sold for $8 million.

DRR has sold 18 pools of assets from Superior since the institution failed on July 27, 2001. One sale of 10 pools was called Scratch and Dent I and consisted of loans that have prior delinquencies and/or had fallen out of previous sales attempts by Superior. The other was the sale of 8 pools of automobile loans, most of which had been written off the books of the failed institution. Both asset sales were advertised using DRR’s electronic mailing list, Listserv, which is open to any party interested in bidding on FDIC asset sales. Electronic mail messages were sent out to over 1,600 interested parties on Listserv.

Each recipient was instructed to complete a confidentiality agreement in order to gain access to asset information on a secured Web site. All parties accessing the secured Web sites had completed confidentiality agreements. Both groups of sales complied with applicable DRR policies and procedures. The conservatorship realized the maximum value for the assets sold through Scratch and Dent I and the automobile loan sales.

Sale of Orangeburg, New York, Assets Complied with Established Policies

The conservatorship maximized the value received for the residual interest assets, the servicer advances, and the servicing rights. The sales of these assets reduced the loss to the Savings Association Insurance Fund (SAIF) from the failure of Superior. The conservatorship was unable to sell either the loan origination or the loan servicing operations.

New Superior’s loan origination and servicing operations managed from Orangeburg, New York, were packaged for sale separately from the other assets of the conservatorship. Four asset packages were designed: loan origination operations, loan servicing operations, servicing rights, and residual interest assets. Qualified bidders were invited to submit preliminary bids on each of these asset packages or on any combination of packages. These preliminary bids were evaluated and then the most competitive bidders were asked to submit final bids on the packages. No final bids were received on either the loan origination or the loan servicing operations. However, the

servicing rights and residual interest assets were sold to one bidder, whose combination bid of approximately $463 million was selected as the best return to the conservatorship. We reviewed the valuation of the asset packages, the bidding process, and the selection process and determined they were in compliance with DRR policies and procedures. Both DRR employees involved in the conservatorship operations and the third-party contractor hired to assist in the resolution process applied DRR's established policies and procedures for the marketing of the assets managed from Orangeburg, New York.

Sale of Deposits to Charter One Complied with Established Policies

The sale of the deposits of the failed Superior complied with the policies and procedures established by DRR. DRR contacted 382 potential bidders to determine their interest in purchasing the deposits and certain assets of the failed Superior. Interested bidders who were deemed qualified by the FDIC were given access to the Intralinks Web site, which contained deposit and asset information about the failed institution. DRR received 19 bids from 9 interested parties and analyzed them using the optimization software, *What's Best!* Charter One, Cleveland, Ohio, submitted the only all-deposit bid with a premium of approximately $52.4 million. This was deemed the best bid submitted, and on October 31, 2001, the FDIC announced the sale of the branches, the deposits, and $45 million in assets of the failed Superior to Charter One.

LOSS TO SAIF EXCEEDS PRELIMINARY ESTIMATES

As of May 14, 2002, the loss to the SAIF for the failure of Superior was estimated at $763 million, nearly $213 million more than originally estimated. A smaller deposit franchise premium and a lower sales price for the residual interest assets contributed to the increased loss estimate. The final loss to the SAIF cannot be calculated until all assets are sold and all expenses are paid.

Given the information available at the time of Superior's failure, DRR estimated that the ultimate loss to the SAIF for the failure would be between $426 million and $524 million. This estimate was not made public at the time of failure, and the FDIC noted in the press release that the final cost to the SAIF would be released upon final resolution of the conservatorship. By the time the FDIC began negotiating with Superior's owners, the loss was generally estimated at $550 million. The cash payment and the value of the promissory note received as part of the settlement were intended to reduce the ultimate loss to the SAIF from the failure.

The Division of Finance (DOF) is currently reserving $440 million for the loss. However, this value was determined after netting the $100 million cash payment from the owners of Superior and the present value for the promissory note of $223 million. Therefore, the loss to the SAIF from the Superior failure, not including the settlement amount is $763 million.

The primary factors in this increase to the loss estimate were the smaller-than-estimated premium on the sale of the deposits and the greater-than-estimated loss on the residual interest assets. These two factors account for approximately $196 million of the approximately $213 million increase in the loss estimate. There are also the $11 million in costs associated with continuing loan origination operations, as well as $10 million in interest paid to the FDIC for borrowings against the line of credit and $4 million in supervisory and insurance fees associated with the newly chartered Superior Federal.

Because Superior was closed only 3 days after being declared critically undercapitalized, DRR was not given its normal 90-day access to the institution prior to failure. Therefore DRR did not have actual numbers to use to estimate the loss at the time of failure. Consequently, there was no way to estimate accurately, at the time of the failure, the cost of the Superior failure. The Least Cost Test[16] is not designed to estimate the actual loss to the insurance fund; it merely compares the relative position of each resolution option (least costly, more costly, and most costly). There are no criteria that require DRR or DOF to estimate the actual loss to the insurance fund at the time of failure. In a "normal" resolution, when the deposits and most assets have been sold before closing, the estimates used in the Least Cost Test are more accurate. If the FDIC had a more accurate loss estimate, then perhaps the settlement with Superior's owners would have been larger and the actual loss to the insurance fund would have been reduced.

[16] The Least Cost Test is used to analyze and compare bids submitted for failing institutions.

LOAN ORIGINATION OPERATIONS LESS VALUABLE THAN ORIGINALLY ANTICIPATED

DRR was unable to determine the value of the loan origination operations prior to Superior's failure because of the limited resolution activities conducted prior to the failure of the institution. Therefore, DRR recommended and the FDIC Board agreed to continue the loan originating operations until a value could be determined. This decision, based on the incomplete data available at the time, drove future decisions and ultimately may have increased the cost of the failure to the SAIF. If DRR had broader access to the failing institution earlier in the resolution process, DRR would have been in a better position to recommend actions to the Board. DRR is addressing the access issue and on April 26, 2002 sought assistance from the FDIC Chairman in initiating a series of meetings with the other federal financial institution regulators with the goal of developing an interagency Memorandum of Understanding (MOU). This MOU would allow DRR staff to have earlier and broader access to problem institutions in order to develop contingency plans in the event of a failure.

DRR was unable to sell the loan origination operations after 5 months because market conditions and unit operating costs made it unattractive to buyers. For the period July 27, 2001 through January 31, 2002, the net cost associated with the loan origination operations was $3.2 million plus $7.9 million in payments owed to the loan production employees under the retention bonus and severance plans.

As part of the Failing Bank Case submitted in support of conservatorship as the least costly resolution option, DRR indicated that a liquidating receivership would have an adverse effect on the value of the assets of Superior, especially the loan origination operations, the loan servicing operations, and the residual interest assets. DRR believed that a conservatorship would allow maximum time to market and preserve the value of these assets. To that end, the conservatorship continued the loan origination and the loan servicing operations located in Orangeburg, New York, until a value could be assigned to these operations.

On September 10, 2001, HanoverTrade.com, the financial services advisor hired by the FDIC, submitted a report indicating that the loan servicing operations had a $0 value and the loan origination operations had a value of between $0 and $5 million. However, HanoverTrade.com's recommendation of a sales strategy included the sale of these two operations concurrently with the sales of the other two asset packages (residual interest assets and servicing rights) since that would allow one bidder to bid on all assets. Preliminary bids on all four packages were due October 25, 2001. At that time, a $2 million bid was received for the loan origination operations, but no bid was received for the loan servicing operations. The loan servicing operations continued to service the residual interest assets until they could be sold.

According to records provided by DRR, from the date of failure through October 31, 2001, net origination costs were approximately $1.7 million. In addition, the New Superior Board of Directors adopted a retention bonus plan at its August 16, 2001 meeting, which estimated payments to the loan origination employees in the Alliance Funding Division of $5.6 million, should the platform be shut down and the employees let go. Therefore, once the decision to continue operating the loan origination platform was made, there was some incentive for the conservatorship to pursue an ultimate sale to avoid the payment of the retention bonus. However, it appears fairly clear, based on both HanoverTrade.com's valuation and the expense

report through October 31, 2001, that the cost of continuing the loan origination operations was greater than the amount the conservatorship could expect to realize through the sale of the operations.

On the final bid date of December 19, 2001, no bids were received on the loan origination operations. DRR informed the FDIC Board of Directors, and the Board authorized DRR to negotiate with the bidders for a negative bid of up to $5 million. This was DRR's best estimate of the costs associated with closing the loan origination operations at that time. It appears that DRR viewed the operating expense costs as "sunk", since either the conservatorship or the receivership would have incurred these costs once the decision to keep the loan origination operations open was made.

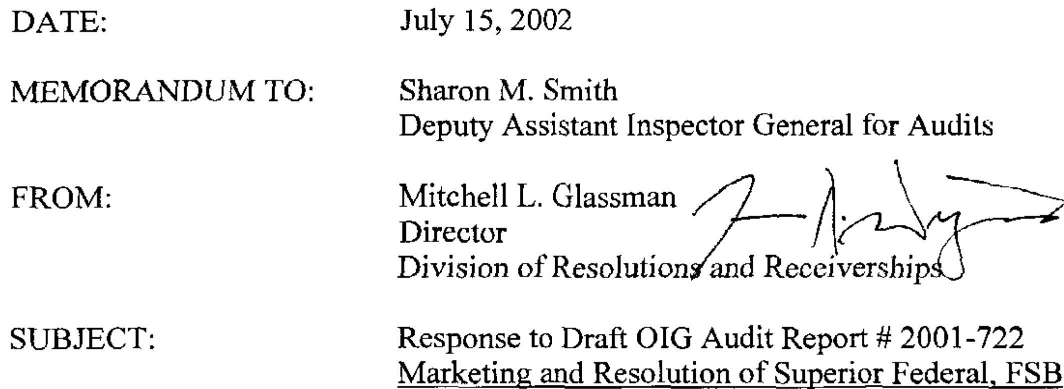
The conservatorship began closing down the loan origination operations in January 2002. From the date of failure through the end of January 2002, net origination costs were approximately $3.2 million. In addition, New Superior paid approximately $7.9 million in retention bonus and severance payments to loan production employees as their jobs were terminated.

Federal Deposit Insurance Corporation
1550 17th Street, NW, Washington, DC 20429

Division of Resolutions and Receiverships
Office of the Director

DATE: July 15, 2002

MEMORANDUM TO: Sharon M. Smith
Deputy Assistant Inspector General for Audits



FROM: Mitchell L. Glassman
Director
Division of Resolutions and Receiverships

SUBJECT: Response to Draft OIG Audit Report # 2001-722
Marketing and Resolution of Superior Federal, FSB

This memorandum will respond to the issues and recommendations in the draft OIG Audit Report dated June 14, 2002.

OIG Audit Recommendation:

(1) We recommend that the Assistant Director, Franchise and Asset Marketing Branch, DRR, ensure that securities sales transactions are valued and documented in accordance with the requirements of the Office of Securities Transactions Procedures Manual.

DRR Response:

We concur with this recommendation. Bidders were selected from a combination of Fintek's list of potential bidders as well as DRR's list of potential bidders. Many of the securities sold were A class mortgage-backed securities; Fintek had many more current market contacts for these types of securities than DRR. FDIC normally passes such securities in bank closings, and DRR works mostly with sales of lower class securities and their buyers. However, to the extent DRR had possible buyers for any securities on Superior's books, those prospects were invited to bid alongside any prospective bidders identified by Fintek. In all cases, bidders had to compete in a competitive auction, where each bidder had equal information on the securities and was unaware of how many other bidders they were competing with in the auction. In the future, DRR will maintain documentation on how the list of potential bidders was compiled.

OIG Audit Recommendation:

(2) We recommend that the Assistant Director, Franchise and Asset Marketing Branch, DRR, in his capacity as the Chairman, New Superior Board of Directors, disallow the $28,043 in questioned professional fees and reimbursed expenses paid to Fintek and seek reimbursement from the company to the conservatorship.

DRR Response:

We concur with this recommendation. It should be noted that DRR management agreed to look into the possibility of offsetting the questioned cost. As noted in the audit report,

> ***"over the period July 27, 2001 through February 12, 2002, Fintek received $1,398,521 in professional fees and $32,273 in reimbursed expenses for a total of $1,430,794. Of this amount, we question $3,741 in professional fees and $24,302 in reimbursed expenses for a total of $28,043, or 2 percent of the funds received."***

DRR on site personnel reviewed all billings for compliance with the terms of the contractual agreement. Billings for out of pocket expenses were kicked back to Fintek. However, John Broderick, who was hired as President by the New Superior Board, negotiated the contract with Fintek. Mr. Broderick approved some of the out of pocket billings based on his understanding of the contract. DRR will ask the Legal Division to determine if there is a reasonable chance of collecting from Fintek for expenses that were approved by Mr. Broderick.

OIG Audit Recommendation:

(1) We recommend that the Assistant Director, Franchise and Asset Marketing Branch, DRR, in his capacity as the Chairman, New Superior Board of Directors, review billings submitted by Fintek since February 12, 2002 and ensure that all payments comply with the terms of the contractual agreement.

DRR Response:

We concur with this recommendation. All billings were review by DRR personnel at the time they were submitted. We will re-review all billings subsequent to February 12, 2002 by September 30, 2002.

cc: James Wigand
Stan Ivie
Giovanni Recchia
Susan Brown
Herb Held
Sandra White
Susan Whited
Dean Eisenberg
Rick Hoffman
Susan Koepp
Robin King