

**Testimony on the Failure of Superior Bank, Federal Savings Bank  
before the  
Committee on Banking, Housing, and Urban Affairs  
United States Senate  
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**I. Introduction**

Good morning, Chairman Sarbanes, Ranking Member Gramm, and Members of the Committee. On July 27, 2001, the Office of Thrift Supervision (“OTS”) closed, and appointed the Federal Deposit Insurance Corporation (“FDIC”) as conservator and receiver of, Superior Bank, FSB, Hinsdale, Illinois (“Superior”). In the 46 days since the government assumed control of Superior, there have been a multitude of news stories, a number of separate federal investigations commenced, and extensive briefings with Congressional staff about Superior. Although the focus of these investigations varies, all are trying to get to the bottom of what went wrong at Superior, how it happened, and what steps can be taken to reduce the likelihood of a similar failure.

That is also, of course, why we are here today. Ultimately, it may take years to complete the full record of Superior’s downfall. We are still at a preliminary stage of the investigation of the details of Superior’s failure. For this

reason, great care is required to avoid mistakes in how we characterize the actions of those we believe are responsible. We have to be equally cautious about tipping off the responsible parties about the course of our investigation.

I have already stressed to you, Mr. Chairman, my strong desire to provide you with as much information and details regarding the failure of Superior as you deem necessary. I have also indicated my concern not to compromise any potential actions that OTS, the FDIC or any other agency may pursue in connection with this matter. I understand from staff that you share this concern. We have done our best to honor these competing interests.

Before getting into Superior, I think it important to clarify a few misperceptions regarding the impact of the failure on the thrift industry and on the Savings Association Insurance Fund ("SAIF"). First, the effect on the thrift industry from the failure is minimal. Although Superior did not close until after the end of the second quarter, at our quarterly press conference last week, I noted that if the failure of Superior were included in second quarter numbers, it would have resulted in a \$1.76 billion reduction, down to \$964.68 billion, in total industry assets at June 30, 2001. Record quarterly earnings of \$2.51 billion would have increased to \$2.54 billion without Superior's loss.

The bigger story, of course, is the impact of the failure on the SAIF. FDIC projections of a \$500 million loss to the SAIF equate to more than a quarter of the institution's assets at the time of failure.<sup>1</sup> If this projection holds, it represents a significant hit to the SAIF, but by no means a deadly blow. Based on unofficial estimates, about a \$500 million loss to the SAIF will reduce its reserve level from 1.43 basis points to approximately 1.37 basis points of SAIF-assessable deposits, still exceeding the current 1.32 basis point capitalization of the Bank Insurance Fund ("BIF") and, more importantly, exceeding the 1.25 designated reserve ratio. While the size of the drop in the SAIF is significant in relative terms, the fund remains strong, as I reported to you in June of this year.

The losses at Superior were so high largely because of that institution's concentration in residuals. The 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.

Competition and innovation in our financial services system have provided tremendous benefits to consumers and have made financial institutions stronger.

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<sup>1</sup> While this is high, it is not the highest percentage for recent failures. Two non-OTS institutions had higher percentage loss estimates. Pacific Thrift and Loan failed in November 1999 and the initial estimated loss was \$49.9 million on assets of \$117.6 million; in the case of Keystone National Bank, estimated losses were in excess of \$300 million on assets of \$1.0 billion.

These same factors, however, pose unique risks and challenges to depository institutions. The challenge is in managing the level of risk taking. While competition encourages institutions to take risks, too much risk taking will undermine an institution's core business strategy. Innovation, a tool institutions use to compete more effectively, can also be overused. An institution that adopts every new financial, operational and technological innovation runs the risk of losing its strategic focus, and its customer base.

As Federal Reserve Board ("FRB") Chairman Alan Greenspan observed before the Conference of State Banking Supervisors in May of this year:

Banking in this country is, in most areas, highly competitive, and the industry has proven itself to be highly resilient. To survive and be effective, banks must be willing and able to take risk. Revenue, shareholder equity, and if necessary the [federal deposit insurance funds] are there to deal with mistakes. Put differently, while public policy needs to limit the financial and social costs of bank failures, we should not view every bank failure as a supervisory or regulatory failure. It is not our role to prevent all failures, let alone to guard against every earnings decline. Indeed, to do our jobs well, we should understand that the essential economic function of banks is to take risk, and that means mistakes will sometimes be made. A perfectly safe bank, holding a portfolio of Treasury bills, is not doing the economy or its shareholders any good.<sup>2</sup>

The key, of course, is for officers and directors to know and understand the risks an institution is taking. This is part of their fiduciary duty to the institution and its shareholders. Increasing involvement in novel and complex financial

transactions requires officers and directors to turn to experts to understand the risks inherent in a new activity. Consulting with experts does not, however, absolve management and directors of their fiduciary obligations; it remains their responsibility to know and understand.

Our system includes other checks to prevent potential problems. Foremost among these is sound supervision and oversight by the federal banking agencies. This brings us to the question whether OTS made the right calls with respect to Superior.

Clearly, decisions were made that we must answer for. Were we too slow to recognize the problems at Superior? As some of the major issues that ultimately brought Superior down began to unfold in mid-1999, were we too slow to act to address problems after they were discovered? We took an increasingly escalating series of formal actions, including, starting in May 2000, a ratings downgrade to CAMELS 4, a directive not to grow, and a notice of deficiency under 12 U.S.C. § 1831, 12 C.F.R. Part 570. We issued a prompt corrective action (“PCA”) directive in February 2001 that required significant operating changes as well as a major capital infusion, and did so before the institution reported itself to be significantly undercapitalized. If there is something we could have done better,

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<sup>2</sup> Remarks by FRB Chairman Alan Greenspan at the Conference of Bank Supervisors, Traverse City, Michigan (via satellite), May 18, 2001.

it would have been – in late 1999 and early 2000 – to put stronger, and more consistent, pressure on Superior’s management and board of directors, and the board of its holding company, to take the actions they said they would, and to do it in a timely manner.

The issue of interagency coordination between OTS and FDIC is popular with some in the press, a dangerous trap for both agencies in litigation, and of little substantive value in reviewing what really went wrong at Superior. Were there occasional disagreements in judgment between OTS and the FDIC about the handling of Superior? Yes. Did this cause Superior to fail? No. Did they increase potential losses to the SAIF? I do not believe so. While individuals from our respective agencies may disagree with each other at times, there is every incentive for OTS, the OCC and the FRB to work with the FDIC to address problem institutions. More significantly, there is definitely value added by having two regulators instead of one working on the same problem. I make that observation from two perspectives—OTS Director and FDIC Board Member.

OTS has extensive experience in resolving the issues and problems confronted by troubled institutions. We are intimately familiar with the tools provided by PCA as well as the other supervisory and enforcement tools afforded by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”) and the Federal Deposit Insurance Corporation Improvement Act of

1991 (“FDICIA”). And we have a good track record in preventing failures, as well as in reducing resolution costs charged to the SAIF. Since 1996, there have been only three thrift failures other than Superior, resulting in total combined losses to the SAIF of less than \$24 million. At the same time, we have successfully dealt with any number of institutions in potential trouble, by recapitalizations, management and board changes, mergers and acquisitions, and voluntary liquidations. Fortunately for the financial system but unfortunately for us in the context of today’s hearing, those successes never make news and no one holds hearings about them.

My testimony today will address the chronology of events leading up to Superior’s failure; discuss the causes of the institution’s failure; and provide some suggestions about what we at OTS, the federal banking agencies working together, other organizations such as the accounting profession, and Congress can do to mitigate the risk of a similar failure.

## **II. Chronological History of Superior**

In December 1988, the Pritzker and Dworman interests acquired Lyons Savings Bank, A Federal Savings Bank, Countryside, Illinois (“Lyons”), a failing institution with \$1.5 billion in assets and \$1.7 billion in liabilities, for a combined contribution of \$42.5 million. The acquisition was made with assistance from the

former Federal Savings and Loan Insurance Corporation (“FSLIC”). Pursuant to the acquisition, the Pritzkers and Dwormans each owned 50 percent of Coast-to-Coast Financial Corporation (“CCFC”), which owned 100 percent of the institution. Lyons was renamed Superior Bank FSB (“Superior”), with its home office in Hinsdale, Illinois, in April 1989.

In connection with the acquisition of Lyons, the Pritzker and Dworman entities asked for and received a waiver from the Federal Home Loan Bank Board of various filing and reporting requirements for all but three holding companies of the acquired institution. The only companies required to file periodic reports and/or financial information were CCFC, UBH, Inc. (“UBH”), and Coast Partners (“CP”), which were all formed for the purpose of acquiring and operating Superior. UBH, controlled by the Dwormans, and CP, controlled by the Pritzkers, remained predominantly shell companies each with their primary activity the ownership of 50 percent of CCFC. CCFC owned Superior and several other small financial services affiliates with operations that complemented Superior.

Throughout the history of Superior, OTS examinations indicated that Superior’s only dealings with holding company affiliates involved either CCFC or its wholly owned subsidiaries. As a result, CCFC and its subsidiaries remained the focus of OTS holding company examinations of Superior.



Superior's activities were severely limited during the first few years of its operation. During its first five years, the institution operated under a FSLIC Assistance Agreement that concentrated management's efforts on resolving problem assets and supporting claims for yield maintenance from FSLIC 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.

While Superior's owners had some difficulty stabilizing their institution, by 1993 both OTS and FDIC had rated it a CAMELS 2. At this point, Superior's management began to focus on expanding the institution's mortgage lending business. The acquisition of a mortgage-banking subsidiary, Alliance Funding Company, Inc. ("Alliance"), from an affiliate at the end of 1992 provided Superior with the ability to expand its mortgage lending business. Alliance is a nationwide consumer finance company that operates as a full service mortgage banker originating or purchasing, on a wholesale basis, mortgage loans secured by first and second liens on one-to-four family homes.

As Superior expanded its mortgage banking activities during the mid-1990's it consistently received a composite "2" rating during safety and soundness examinations from 1993 through 1996. In 1997 OTS gave it a "1" rating. The FDIC was on site for the July 1993 exam and reviewed OTS' exam report off-site for the August 1994, September 1995, October 1996 and December 1997

examinations. During this period, FDIC did not dispute OTS' overall composite rating of Superior.

Starting in 1993, Superior built its mortgage banking business. And, as with most mortgage bankers and an increasing number of subprime lenders at the time, Superior was, in general, not holding the loans in portfolio. Rather it was securitizing the loans—the process by which a pool of loans is divided into securities of varying levels of credit quality and sold to investors with varying appetites for risk. And Superior, like many issuers, held on to the security with the greatest amount of risk or otherwise provided significant credit enhancement for the less risky securities. These include interest-only or I/O strips, spread accounts, and cash collateral or overcollateralization accounts, and are collectively known as “residuals” because they receive the last cash flows from the loans.

In December 1998, OTS scheduled an examination of Superior commencing in January 1999. At this time, Superior Bank was rated “1” by OTS and well capitalized. Although the FDIC Regional Director requested to have one examiner join OTS at this examination, he agreed to alternate arrangements with the OTS Regional Director. Under the arrangement, the FDIC reviewed OTS's work papers off-site during the latter part of OTS's exam. If the FDIC had questions based on the OTS work, OTS agreed to present those issues on behalf of the FDIC to Superior's management. This arrangement was made because the

institution was concerned about giving an FDIC examiner full access to its books and records while in the midst of litigation with the FDIC over a tax sharing agreement arising out of the original acquisition of the institution from the FSLIC.

During 1999, both OTS and the FDIC started having serious concerns about the institution. Early in the year, OTS focused its attention on the inadequate asset classification system, which led to inaccurate loss reserves and regulatory accounting, as well as on the deteriorating auto portfolio. OTS rated the institution a “2” in March. The FDIC was more focused on the increasing concentration of residuals and rated it a “3” in May. But by July 1999, both agencies were increasingly focused on both the concentration and the valuation of residuals. The institution’s management and the rating agencies did not see a problem. In May 1999, Fitch, which rated Superior’s long term debt an investment-grade BBB, stated:

Superior, with assistance from CCFC and its financial management affiliate, has developed and executed business strategies related to the origination, securitization and servicing of non-prime consumer assets that have led to strong operating results in recent years. . . . Important to evaluating the company’s performance is our assessment that Superior uses appropriate assumptions in recognizing FAS 125 income. Furthermore, the company’s process for valuing related financial receivables, recognizing adjustments on a quarterly basis when applicable, is viewed positively. Extensive analysis of historic prepayment and credit performance of existing loan pools provides a basis for rational accounting. Superior’s strict adherence to its internally generated risk-based pricing parameters has also contributed to slower, but generally more profitable, loan origination growth than its competitors.

In May 1999, through discussions between FDIC and OTS regional staff, it was agreed that the FDIC would participate with OTS on the next regular safety and soundness examination at Superior. This agreement was formalized in writing by the FDIC in September 1999. OTS provided written concurrence.

With more institutions getting involved in securitizations, and with the OCC's and FDIC's experience with the Keystone and Pacific Thrift and Loan failures in late 1999, the federal banking agencies ("FBAs") issued interagency guidance on asset securitizations in December 1999. Shortly thereafter, in January 2000, concurrent OTS-FDIC examinations of Superior commenced. OTS raised significant supervisory concerns regarding Superior's securitizations and exposure to residuals in the report of examination. Based on that report, OTS downgraded Superior's composite rating to a "4" from the "2" rating assigned to the institution in 1999. The downgrade was primarily attributed to the significant concentration of residual assets on the books of Superior. The FDIC also assigned Superior a 4 overall composite rating.

In the May 2000 transmittal of Superior's January 2000 examination report, OTS advised Superior's management to take the necessary steps to increase capital or reduce the risk inherent in the institution's operations. OTS also required, among other things, that Superior make all necessary adjustments to capital as of March 31, 2000, ensure that the Allowance for Loan and Lease

Losses (“ALLL”) was sufficient to cover risks, and appropriately classify assets. OTS also notified Superior that because its capital level had fallen to “adequately capitalized”<sup>3</sup> it could no longer accept new, or renew maturing, brokered deposits.

As a result of OTS’s examination report, OTS sent to Superior’s board of directors on July 5, 2000 a notice of deficiency and requirement for submission of a 12 C.F.R. Part 570 safety and soundness compliance plan pursuant to section 39 of the Federal Deposit Insurance Act. The notice of deficiency required Superior’s board to take action, including the following:

- Develop procedures for analyzing the ongoing fair market value of the institution’s residual assets;
- Obtain periodic independent valuation of a sample of receivables;
- Develop a plan to reduce the level of residual assets to no greater than 100 percent of Tier 1 (core) leverage capital within a one-year time period;
- Revise the institution’s automobile lending policy and establish performance targets for its automobile lending operation; and
- Develop a revised ALLL policy and maintain adequate loan loss reserves.

Because of OTS’s concern regarding the concentration in residuals, Superior’s board ceased securitizing loans at the thrift and, instead, sold newly

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<sup>3</sup> Superior was adequately capitalized on a risk basis. Tier 1 equity capital exceeded 12%, in the well-capitalized range.

originated loans to its holding company. This stopped the growth of residuals at the institution. OTS also forwarded a supervisory letter to Superior on July 7, 2000 officially notifying the institution of its designation as a problem institution, as defined in Regulatory Bulletin 27a, and in troubled condition pursuant to 12 C.F.R. § 563.555. The notice prohibited asset growth, except in the amount of interest on deposits, and placed restrictions on new employment contracts and hiring of senior officers, required regulatory approval of third party contracts outside the normal course of business and disallowed “golden parachute” payments. The FDIC’s Chicago office indicated its concurrence with this supervisory strategy.

Superior’s board submitted a compliance plan to OTS on August 4, 2000. The board’s response indicated that procedures were being developed and implemented, with the assistance of Ernst & Young (“E&Y”), to value the institution’s residual assets. The board had developed a plan to transfer the residual assets from the books of Superior to CCFC, and its affiliates, within the requested time frame. In addition, the institution’s subprime automobile lending operation had been terminated and adequate loan loss reserves were established. The institution ceased its securitization activities as of June 30, 2000, but continued to originate loans for sale to its holding company and its affiliates, with the servicing retained by Superior.

OTS made additional information requests on September 1 and October 27, 2000, with regard to the institution's compliance plan, and the board's responses were received on September 29 and November 13, 2000, respectively.

During review of the institution's compliance plan, OTS and FDIC commenced a field visit examination on October 16, 2000. Due to significant problems that were identified, the field visit continued into early 2001. The field visit was conducted to review Superior's progress in calculating the fair market value of its residual assets; to determine management's compliance with the corrective action required by the January 24, 2000, examination; and to review and determine the board's compliance with OTS' July 7, 2000, supervisory letter. The field visit exam report disclosed that Superior's financial statements for June 30, September 30 and December 31, 2000 contained significant errors. The fair market value analysis of the residual assets had not been completed. Management also failed to implement several of OTS's January 24, 2000, examination instructions and continued to delay required adjustments to the financial statements during the course of the field visit.

In October 2000, E&Y issued their audit of Superior's fiscal year ending June 30, 2000. OTS and FDIC undertook a review not only of the audited financials but also the underlying workpapers. Additionally, during this time, OTS and FDIC accountants had meetings and discussions with E&Y and Superior

regarding whether GAAP had been appropriately applied to the overcollateralization accounts.

Pursuant to the field visit, OTS communicated to Superior's management on November 15, 2000, that Superior's residual assets were significantly overstated at June 30, due to the absence of acceptable valuation procedures and the use of incorrect accounting treatment. The examiners, with the assistance of the OTS and FDIC accountants, determined that Superior, notwithstanding representations to the contrary, was not accounting for the residual assets in compliance with Statement of Financial Accounting Standards ("SFAS") No. 125. Superior overstated the value of its residual assets when it failed to properly recognize the impact of timing delays in the receipt of cash flows on the overcollateralization ("O/C") assets within the residuals retained on its books. E&Y failed to take exception to this improper reporting.

The O/C assets are a credit enhancement on the securitizations pledged for the benefit of the REMIC bond insurer and trustee. E&Y provided an unqualified audit opinion even though management erroneously accelerated the receipt of the estimated cash flows from the underlying loans related to the O/C assets. These cash flows would not be released by the trustee and received and retained by Superior until much later in the life of the REMIC trusts. This error caused Superior to report inflated assets, earnings and capital. Combined with other



valuation adjustments, the examiners estimated an appropriate write-down of the residual assets might exceed \$200 million.

In addition, OTS's and FDIC's October 2000 field visit disclosed that Superior's management and board of directors failed to take certain actions to ensure that the books and records accurately reflected the true financial condition of the institution. These actions primarily involved the failure to recognize various write-downs applicable to the institution's automobile loan operations. The examiners determined that, although portions of the required write-downs were implemented, three material adjustments totaling approximately \$13 million were not recorded. Therefore, OTS directed Superior's board to make these adjustments.

In light of the major adjustments that appeared likely in Superior's financial statement, OTS's focus shifted from completing the Part 570 plan process to consideration of a PCA Directive pursuant to section 38 of the FDIA.

On December 19, 2000, OTS and FDIC again met with Superior and E&Y to discuss the accounting treatment applied to the residual assets. OTS advised the institution that the accounting treatment was incorrect and a significant adverse valuation adjustment to these assets was necessary. Management and E&Y

continued to disagree. OTS insisted that the issue be raised with E&Y's national office.

On January 11, 2001 in a meeting with Superior, E&Y, and the regulators a national review official for E&Y acknowledged that the accounting treatment applied by E&Y to the residual assets was incorrect, although E&Y did not agree as to the amount of the adjustment. E&Y proposed a Reevaluation of Retained Interest Accounting Work Plan for the reevaluation of the residual assets, with updates to the OTS every two weeks. The work plan proposed to revalue the respective assets using the correct accounting methodology from the date of inception for each of the securitization pools. The revaluation later resulted in a write-down of the residual assets in the amount of \$270 million.

Two key management officials at Superior were replaced in early 2001, after the January 11, 2001 meeting. Nelson L. Stephenson resigned from Superior's board on January 22, 2001. Mr. Stephenson had been a director since 1990 and Chairman since 1997. Mr. Stephenson was instrumental in developing and coordinating loan securitization and sales activity at the institution. Mr. Stephenson was replaced as chairman by Stephen Mann. Mr. Mann was originally hired by Superior as a consultant to analyze and negotiate acquisitions and strategic alliances. After the January 11, 2001 meeting, William C. Bracken was replaced as Chief Financial Officer ("CFO") and Secretary of Superior. Mr.

Bracken was a key management official of the institution and had the responsibility for classified asset reporting and verification of the major assets of Superior. Walter F. Rusnak replaced Mr. Bracken as CFO and Corporate Secretary.

On February 12, 2001, OTS notified the board of directors of Superior that the capital ratios of the institution were in the “significantly undercapitalized” PCA category. This condition was the result of various adjustments made by Superior in conjunction with the January 24, 2000, examination report as well as those made by Superior to the risk weighting of certain assets. This conclusion was also based upon OTS examiners’ findings communicated to the institution during the October field visit. Superior’s board was directed to submit a PCA Capital Restoration Plan (“Capital Plan”) by mid-March. Superior also became subject to requirements and/or restrictions pursuant to Section 38 of the FDIA.

On February 14, 2001, OTS issued a PCA directive to Superior based upon OTS’s determination that the institution was “significantly undercapitalized.” The PCA directive required that Superior originate only loans that it had forward commitments to sell, and to sell all loans originated by the institution on a weekly basis. In conjunction with the PCA directive, the institution’s holding companies, SHI and CCFC, consented to the issuance of a cease and desist order to fund an escrow account at Superior, to be at least \$5 million at all times, that would cover

any losses from Superior's weekly sales of mortgage loans. The order also prohibited the holding companies from incurring any new debt or making capital distributions.

On March 2, 2001, Superior amended its December 31, 2000, TFR to reflect the adjusted valuation of its residual assets under SFAS No. 140 as well as required write-downs. On March 14, 2001, an off-site examination was conducted at Superior to review recent changes in the institution's capital, earnings, liquidity and sensitivity positions. Based upon the analyses performed during this exam, on March 16 Superior was assigned a composite exam rating of 5, a downgrade from the composite 4 rating in the January 2000 exam. The FDIC also downgraded Superior to a 5.

On March 14, 2001 Superior submitted the first version of a Capital Plan, as conceived by its shareholders and approved by the board. That same day, OTS and FDIC commenced regular safety and soundness examinations at Superior. Although not finalized, OTS's exam report again proposed a composite rating of "5" for the institution. The examiners determined that the institution's low capital level, concentration of high risk assets, and large operating losses required an immediate capital infusion for Superior to become a viable institution. The findings disclosed that an additional reduction of the fair market value of the

residual assets was warranted, potentially causing the institution to become “critically undercapitalized” and insolvent.

Because of the problems with erroneous accounting interpretations, accurate audited financial information on Superior has not been available for at least the past three fiscal years (since June 30, 1998). The institution’s most recent independent audit was completed as of June 30, 2000 by E&Y. The accompanying financial statements do not accurately reflect the fair market value of Superior’s residual assets under Generally Accepted Accounting Principles (“GAAP”). E&Y was not retained to perform the institution’s audit work for the year ended June 30, 2001.

On March 30, 2001, CCFC made a temporary capital infusion into Superior in order to keep the institution above the “critically undercapitalized” PCA category pending completion of its Capital Plan. CCFC transferred to Superior its beneficial interest in residual assets in seven securitization pools with an estimated value of \$81.0 million. Without the infusion, Superior’s PCA designation would have been downgraded to “critically undercapitalized” as of March 31, 2000.

In April, FDIC’s Division of Resolutions and Receiverships began to send staff into Superior in anticipation of a possible closure of the institution, should a capital plan not be adopted and implemented.

On May 7, 2001, OTS demanded that CCFC repay a \$36.7 million receivable owed to Superior. CCFC responded that it would repay the receivable when the Capital Plan was implemented. In the interim, Superior's management indicated it would collect monthly interest from CCFC. The receivable was classified as a loss after Superior failed to implement the Capital Plan.

On May 24, 2001, OTS, with non-objection from the FDIC, approved the Capital Plan submitted by Superior on March 14, 2001, as amended on April 30, May 15, and May 18, 2001, including revisions received by OTS on May 19 and May 21, 2001. The Capital Plan included the following strategies:

- Reduce the level of risk currently present in Superior's operations by removing the residual assets from the institution's balance sheet and replacing them with cash and low risk mortgage backed securities;
- Recapitalize the institution to a position of regulatory capital compliance; and
- Restructure operations to return the institution to a financially healthy and profitable entity on a going forward basis.

The Capital Plan included an aggregate cash infusion of \$270 million by the Pritzker and Dworman interests, with the Pritzkers contributing \$210 million, the Dwormans contributing \$50 million, and CCFC contributing the remaining \$10 million. A portion of the Pritzker contribution would be leveraged, resulting in a net benefit to the thrift of at least \$450 million, net of associated pledged

assets. As provided in the Capital Plan, these strategies were to be implemented between 30 and 60 days from the approval date of the plan, but no later than July 23, 2001. OTS also received joint and several guarantees of up to \$100 million of performance of the Capital Plan by eight of the holding companies, including several family trusts.

The Capital Plan required a number of cost-cutting actions at the bank in addition to the capital infusion. These included reducing staff, cutting out unprofitable lines of business, closing various loan production offices, hiring new management and acquiring new board members. From May 24, when the plan was accepted, to July 16, although there were a few disagreements about reporting, Superior was diligently working toward implementation. For example, from March 31 to closure, the number of employees declined by approximately 500. Greenwich Capital, the entity that was to finance the transaction, confirmed that things were moving toward successful implementation.

On July 16, 2001, the Pritzker interests forwarded a letter to OTS indicating that they no longer had confidence in some of the projections they used in developing their Capital Plan. They indicated that, despite their original projections, it was now their view that the future cash flows from the institution's residual assets would not be sufficient to support their strategy in the Capital Plan to remove the residuals from Superior's books. The correspondence concluded

that it was now their opinion that their Capital Plan would not work and, therefore, they were not prepared to support it.

By letter dated July 21, 2001, OTS responded to the Pritzker's July 16 correspondence. OTS indicated that, even under the most extreme case set forth in the Pritzker's modified projections, it appeared that the concerns expressed by the Pritzker interests would not be an issue until many years later. OTS's correspondence also noted that under the base case cash flow numbers set forth in the Capital Plan, the pledged assets supporting the residuals would be unaffected. More importantly, under either set of assumptions, the projections for the first several years would have kept the institution in capital compliance upon implementation of the Capital Plan. OTS's correspondence concluded with the demand that the Pritzkers fulfill their obligations under the Capital Plan.

Subsequent to receipt of the July 16, 2001, letter, OTS and the FDIC together held a number of meetings with the Pritzker and Dworman interests, separately, without success. 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.



### **III. Subprime Lending, Securitization, and Residual Valuation**

The following discussion is intended to highlight the risks associated with subprime lending, how the process of securitization, particularly combined with the retention of receivables, can dramatically increase such risks, and what can be done to control these risks.

#### **A. Subprime Lending**

The growth in subprime lending over the last decade means that more credit has been made available to families that had previously faced very limited credit opportunities. Technological advances in financial markets have enabled lenders to gather, analyze, and process more information more quickly. Lenders have developed management systems that effectively increase the likelihood of repayment of these higher risk loans. Financial market developments in securitizing subprime loan pools have made more funding available for subprime lending at attractive rates.

Yet subprime lending is not simply prime lending with a little more risk. The difference is not just the degree of risk but also the kinds of risk and their complexity. Subprime loans not only default more frequently than prime loans, they also prepay both when interest rates decline and when credit worthiness

improves. Prepayment risk is, therefore, greater for subprime loans. Unlike prime mortgages, older subprime mortgages can be riskier because in general, even with prepayment penalties, loans often will prepay if the borrower's credit improves. Sudden changes in economic conditions or in interest rates can cause losses to mount quickly and high market valuations to disappear.

Increased competition in the subprime market has significantly narrowed lending margins, encouraging institutions to specialize in what they believe to be their strengths. For many subprime lenders, profit centers in the origination and servicing of subprime loans, not in holding them in portfolio. To finance greater levels of originations and servicing, institutions engaged in subprime lending have often turned to securitization, rather than deposits, as a major funding source.

Access to capital markets through securitization allows loan originators to enhance their liquidity, diversify and lower their funding costs, manage interest-rate risk, build operational economies of scale, and help manage credit risk. Risks from securitization arise from problems funding aggressive growth, over-dependence on a highly credit-sensitive funding source, creation of accelerated and unrealized earnings, and less sound, more volatile balance sheets from leverage and concentrated residual risk, all of which are compounded in the case of subprime lending. Each of these issues will now be discussed in more detail.

## **B. Securitization**

Securitization provides a mechanism by which an institution can convert a pool of loans into a mix of top investment grade, highly marketable securities (typically sold for cash), and lower grade, subordinate credit-risk-concentrated securities. This financial alchemy is achieved by reappportioning the cash flows (interest and principal payments) from the loan pool to the security holders in the order of their seniority. In essence, the cashflows from the entire pool of loans create a waterfall. Obligations to senior security holders are met first, with remaining cash, if any, cascading down to more junior securities in order of their priority. Any remainder after all other obligations are met is apportioned to the residual security holder.

Any shortfall in cash flows due to losses in the loan pool affects the residual security holders first, because they are the last to be paid. The residual security holder is in a “first dollar loss” position and thus is exposed to the risk of the entire loan pool. Should the shortfall from the loan pool be sufficiently large, the security holders in the “second-dollar loss” position will be affected next. In essence, each subordinate position provides a credit enhancement to the more senior securities because it stands below it in terms of access to the cash flows of the entire loan pool. The lower yield on high-quality, low-risk senior securities may offset the higher yields required on more junior positions. This is especially

true if the issuer, who is in the best position to evaluate the credit quality of the loan pool, keeps the most risk-exposed subordinate positions. In essence, the issuer is certifying the quality of the pool by a willingness to be exposed to the most risk.

### **C. Risks of Securitization**

Securitization provides a means to fund substantial origination growth by reducing the link between the financial performance of the issuer and the risk of the securities. This ability to leverage origination capacity and supplement revenues through servicing fee income has been an important benefit for financial institutions. Accompanying this relaxation of funding constraints, however, is increased exposures in areas such as operational capabilities. This is especially evident when originators attempt to increase volume by migrating to lower quality borrower classes where servicing costs and techniques can vary widely and increase dramatically. A number of monoline and specialty finance institutions, particularly subprime lenders, fund a substantial portion of their activities through securitization.

The extensive reliance on securitization as a funding source creates incentives for institutions to engage in questionable market practices to ensure the continued availability of funding. Most, if not all, of the “pressures” associated

with institutions surreptitiously retaining risk and implicitly supporting previous securitizations have their roots in the desire to maintain ongoing market access at cost effective pricing. This pressure grows exponentially when securitization becomes the only viable method of funding ongoing operations and meeting business objectives. The substantial fixed costs associated with establishing and maintaining origination and servicing facilities and staff require a continual high volume of loan originations and securitizations. Competitive pressures from firms entering this business have also exacerbated these problems by narrowing margins and increasing prepayments as borrowers refinance, leaving one lender for another.

As the securitization market has matured, issuers have offered incremental changes in their obligations and structural credit enhancements to increase the value of their investment-grade securities. Examples include revolving-asset structures, typical in credit card securitizations, and seller-provided credit enhancements such as cash collateral or spread accounts. The extent to which an institution had transferred risks of the loan pool to outside investors became much more difficult to ascertain with the advent of these new credit enhancements. Liberal assumptions made by institutions regarding, for example, seller-servicing actions and residual asset valuations, and the complexity of accounting rules made the determination of the extent of retained risk and the valuation of the retained interests difficult. One of the most contentious issues arising out of subprime

securitizations is the valuation of retained subordinate positions – residuals, and seller-provided servicing.

#### **D. Seller-Provided Servicing**

Seller-servicing is quite common in some product types, such as in the subprime market, as seller-servicers are often specialists in a product or transaction type and can provide the most efficient execution. The primary duty of a servicer is the collection and pass through of funds from the underlying borrowers to the trustee and/or investors. Other duties include loss mitigation and workout, investor accounting, custodial account management, collateral protection through foreclosure, and escrow management.

Servicer-related issues have become a growing concern. One factor fueling this has been the aggressive migration of originators into subprime and/or lower quality asset types, and the growing number of instances where originators are providing both servicing and credit enhancement to the same transaction. This combination has raised new issues regarding the assumption of risk for seller-servicers that may be able to mask losses by artificially keeping loans current through servicer advances. The concern is that investors receive principal and interest payments from loans that are not paying as agreed without exhausting existing credit enhancement for the privilege, a problem similar to that which

surfaced in the Best Bank failure. The issuer benefits by continuing to recognize inflated over-collateralization assets on its balance sheet.

### **E. Residual Interests**

Structural enhancements that involve a seller's retention of risk typically take two forms. First loss positions, where an originator offers its right to excess interest income (after servicing, coupon payments, and normal loss expectations) and/or a cash collateral account, are designed to cover some small multiple of expected losses on the underlying asset pool. Second loss positions, where an originator may retain a subordinated interest in the securitized asset pool or pledge additional assets as an overcollateralization cushion, are designed to cover more severe or "catastrophic" levels of loss. Collectively, these exposures are referred to as "residual interests" for accounting and risk-based capital purposes.

Because residual interests are often carried on the balance sheet and have no current regulatory limitations on the amounts booked, several regulatory concerns have arisen. First, examinations have repeatedly encountered inconsistency and over-optimism in the initial and ongoing valuation of residual interests. Questionable valuation methods have included incorrect cash flow modeling, unsupported loss assumptions, inaccurate prepayment estimates, and inappropriate discount rates. As residuals generally have no liquid secondary

market, their estimated market values are difficult to verify. This lack of verifiability has sometimes led to extended disagreements with institutions and their accounting firms about proper valuation.

Second, residual interests are exposed to a significant level of credit and interest rate risk that make their values extremely sensitive to changes in the underlying assumptions. This sensitivity is magnified in the case of subprime residuals. As a result, these volatile residual interest assets provide little real capital support, particularly in times of stress.

#### **F. Subprime Securitizations and Valuation Issues**

Securitized subprime loan pools present an even greater challenge to the proper valuation of residuals and servicing rights for several reasons. First, by definition, subprime loans are extensions of credit to borrowers with weak credit histories. The ability of these borrowers to make loan payments is very sensitive to changes in overall economic conditions. For example, the recent slowdown in the economy has led to a substantial increase in subprime mortgage delinquencies, while, so far, having little impact on the performance of prime mortgages.

Second, insured institutions' involvement in the subprime market has not been tested during a period of prolonged economic downturn. Higher than



expected default rates reduce the value, sometimes dramatically, of both residual assets (since these are in the most junior position) and the servicing rights, as future payments cease and collection costs increase when loans default. As this occurs, book values of residual assets and the servicing rights should be written down. This will swiftly lower the level of regulatory capital for institutions with high levels of residual assets and servicing rights.

Third, subprime borrowers will refinance their loans to reduce interest costs if overall interest rates drop sufficiently to overcome disincentives to prepayment, as they have recently, or as borrowers' credit ratings improve. This second factor (credit-induced prepayment) is not present in prime mortgages and further complicates the valuation of servicing rights, as prepayments for either reason stops servicing income.

Fourth, some institutions have been able to use residual interests and gain-on-sale accounting (*i.e.*, the immediate recognition of the present value of expected future cash flows) to improve their capital positions by securitizing assets. This happens most often when an originator securitizes higher-risk assets such as subprime loans. As an example, the overcollateralization requirements for an investment-grade security rating for a pool supported by subprime loans is typically higher than the full 8 percent capital charge assigned when such loans are on an institution's balance sheet. In this instance, the institution can use gain-on-

sale accounting provisions to improve its capital position even though its risk exposure has not changed.

Finally, gain-on-sale accounting for residuals provides a strong incentive for companies to grow origination volume, sometimes to unsustainable levels. Since securitization gains are directly proportional to the volume of loans securitized, in some cases the primary source of ongoing earnings growth is increased loan origination and securitization volume. This may eventually lead to the dilemma where market conditions warrant a reduction in loan origination volume, however, the result would be to reduce both reported earnings and the institution's stock price.

### **G. Regulatory Responses**

With respect to subprime lending, OTS first raised concerns in June 1998. This was followed by interagency guidance on subprime lending in March 1999. That guidance stressed the management and operational challenges in subprime lending, and cautioned of the need for increased capital and reserves. In January 2001, the FBAs issued expanded and supplemental guidance intended to strengthen the examination and supervision of institutions with significant subprime lending programs.

The January 2001 guidance principally applies to institutions with substantial subprime lending programs that equal or exceed 25 percent of an institution's Tier 1 regulatory capital. The guidance instructs examiners to consider, based on the size, concentration level, and relative risk of an institution's subprime lending activities, the following elements:

- Portfolio growth rates;
- Trends in the level and volatility of expected losses;
- The level of subprime loan losses incurred over one or more economic downturns, if such data/analyses are available;
- The impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets;
- Any deterioration in the average credit quality over time due to adverse selection or retention;
- The amount, quality, and liquidity of collateral securing the individual loans;
- Any asset, income, or funding source concentrations;
- The degree of concentration of subprime credits;
- The extent to which current capitalization consists of residual assets or other potentially volatile components;
- The degree of legal and/or reputation risk associated with subprime business line(s); and
- The amount of capital necessary to support an institution's other risks and activities.

Because of the elevated risk levels, examiners were also warned that the quality of subprime loan pools may be prone to rapid deterioration, especially in the early stages of an economic downturn. The guidance indicated that sound underwriting practices and effective control systems can help provide the lead time necessary to react to deteriorating conditions, while sufficient allowance and capital levels can reduce their impact.

In December 1999, in response to the increased use of securitizations by institutions, the federal banking agencies (“FBAs”) published *Guidance on Asset Securitization* (“Securitization Guidance”). The interagency guidance addressed supervisory concerns with risk management and oversight of these securitization programs. The Securitization Guidance highlighted the most significant risks associated with asset securitization, and emphasized agency concerns with certain residual interests generated from the securitization and sale of assets. The guidance also set forth fundamental risk management practices that the agencies expected of institutions that engage in securitization activities.

The Securitization Guidance stressed the need for institution management to implement policies and procedures that include limits on the amount of residual interests that may be carried as a percentage of capital. The guidance stated that, given the risks presented by securitization activities, the FBAs would be considering regulatory restrictions that limit or eliminate the amount of certain

residual interests that could be recognized in determining the adequacy of regulatory capital.

In September 2000, the FBAs published a notice of proposed rulemaking on residual interests in asset securitizations or other transfers of financial assets (“Residuals Proposal”).<sup>4</sup> The proposal was intended to address the agencies’ concerns with residual interests highlighted in the Securitization Guidance. The Residuals Proposal defined residual interests and required a dollar-for-dollar capital charge against risk-based capital, that is, residuals would be counted neither as assets nor capital for risk-based capital purposes. The FBAs further proposed a deduction from Tier 1 capital of the total amount of residual interests held by an institution in excess of 25 percent of Tier 1 capital. This, in effect, creates a concentration limit because of the severity of the capital requirement.

The FBAs received many comments on the Residual Proposal from banks and thrifts, law and accounting firms, trade associations, and government-sponsored enterprises. Several commenters opposed the proposed capital treatment, believing that concerns associated with residual interests should be handled on a case-by-case basis under the existing supervisory authority. Many of these comments referenced the Securitization Guidance, which highlighted the supervisory concerns associated with residual interests.

Even before the events that unfolded with Superior, OTS had significant concerns with the credit risk exposure associated with deeply subordinated assets, particularly below-investment grade and unrated residual interests. While the dollar-for-dollar capital requirement could result in an institution holding more capital on residual interests than on the underlying assets had they not been sold, in many cases the relative size of the retained exposure by an originating institution provides insight into the quality of the securitized asset pool. In other words, large residual positions often serve as a signal of the lower credit quality of the sold assets. The dollar-for-dollar and concentration requirements would also reduce an institution's ability to leverage its balance sheet based on the gain on sale accounting for residual interests.

To most effectively implement our guidance on subprime lending and securitization, as well as any new capital regulation, it is critical that the agencies receive more and better quality information, on a regular basis, preferably through the TFR and Call Reports, on both subprime lending and residual holdings. OTS in March of this year and the other FBAs in June began to collect data on residuals, but the quality needs to be improved. All agencies are working toward a proposal to begin collecting data on subprime lending.

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<sup>4</sup> See 65 Fed. Reg. 57993.

#### **IV. Accounting and Financial Reporting Issues**

OTS's experience with Superior highlights a number of accounting and financial reporting issues, and other problems confronting all of the FBAs. These include problems with GAAP as it is applied to the regulatory reporting requirements of the FBAs, and problems with SFAS No. 140 (which replaces SFAS No. 125) and gain-on-sale accounting. In addition, the independent role of external auditors and their training and experience with complex financial instruments and transactions are issues raised by our experience with Superior. Finally, perhaps the most vexing issue confronting the FBAs in this area is how to resolve disputes and disagreements between FBA examiners, and outside accountants, especially when such disputes implicate regulatory capital levels.

##### **A. Regulatory Reporting Consistent with GAAP**

Since 1997, regulatory reporting by banks and thrifts on both the bank Call Report and the TFR has been in accordance with GAAP. Although this approach has several benefits, including uniformity, it incorporates into regulatory accounting practices ("RAP") certain GAAP accounting practices that have been troublesome for effective bank supervision. One such practice is "gain-on-sale" accounting.

The accounting and reporting for securitizations and residual interests is dictated by SFAS No. 140,<sup>5</sup> which was issued in September 2000. Under SFAS No. 140, a transfer of loans in a securitization transaction where control of the loans is deemed to have been surrendered must be accounted for as a sale. The various criteria for transfer or surrender of control under this standard were established from a legal point of view. Therefore, sale recognition is not dependent on a transfer of risks and rewards. Where the transfer has been accounted for as a sale, and where the proceeds exceed the cost, the seller must report a gain on the sale. This is so even if the seller has (1) significant continuing involvement with the assets sold, including recourse, and (2) retained substantial non-cash assets, such as residual interests.

A gain typically results where the seller retains a residual interest in the loans. An example is illustrative of the problem. In a securitization transaction in which loans with a face amount of \$1,000 are sold for cash proceeds of \$980, and a residual interest with a fair value of \$50 is retained<sup>6</sup>, the transaction will produce the following results:

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<sup>5</sup> SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," replaced SFAS No. 125, issued in 1996 and effective in 1997.

<sup>6</sup> The total value exceeds the face amount of the loans because it includes the discounted expected future cash flows (e.g., interest payments and late fees).



The transaction produces a “cash loss” of \$20, computed as follows:

Cash proceeds		\$ 980
Cost of loans		<u>(1,000)</u>
Cash gain (loss) on sale of loans		<u>\$ (20)</u>

Under SFAS No. 140, however, a “gain-on-sale” of \$30 is reported,<sup>7</sup> computed as follows (using a simplified method):

Cash proceeds		\$980
Cost of loans	\$1,000	
Retained residual interest	<u>(50)</u>	
Net cost	<u>\$ 950</u>	<u>(950)</u>
Gain-on-sale		<u>\$ 30</u>

The “gain-on-sale” of \$30 can be reconciled as follows:

Cash gain (loss) on sale of loans		\$ (20)
Retained residual interest		<u>50</u>
Gain-on-sale		<u>\$ 30</u>

Under SFAS No. 140, fair value is the amount at which an asset could be bought or sold in a current transaction between willing parties, other than in a forced or liquidation sale. This implicitly permits the use of more favorable valuation assumptions as to prepayments, credit losses, and discount rates than are used by buyers when such interests must be sold in a forced sale. However, we understand that most sales of residual interests are in a forced or liquidation sale. Under such circumstances, the price paid is usually substantially lower than the

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<sup>7</sup> Under the “allocated cost based on relative fair value method”, as required by SFAS No. 140, would actually result in a retained residual interest of \$49 and a “gain-on-sale” of \$29. For purposes of this example, the \$1 difference is not significant.

fair value, which is the amount at which the asset is carried on an institution's books. As a result, substantial losses are reported on these sales.

While SFAS No. 125 established the original gain-on-sale requirements, SFAS No. 140 added additional disclosure requirements with respect to residual interests, which became effective in late 2000<sup>8</sup>. Companies must now disclose their critical assumptions as to prepayments, credit losses, and discount rates on an aggregate basis. Although this may subject the valuation of these assets to greater market discipline, because the disclosures may be made on an aggregate basis, they may not be sufficiently detailed for bank supervisory purposes.

OTS and the other FBAs already have statutory authority to remove from regulatory reporting the undesirable accounting practice of gain-on-sale. However, this authority has seldom, if ever, been used to address undesirable accounting practices that are required under GAAP. Doing so could create "RAP/GAAP" differences and add to regulatory burden. Most RAP/GAAP differences that existed in the 1980s and early 1990s were eliminated for this very reason. Nevertheless, in light of the very substantial concerns we have had with

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<sup>8</sup> Emerging Issues Task Force ("EITF") Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets", which became effective in June 2001, established additional requirements for the recognition of income and impairment in the accounting of residual interests.

the valuation of residuals and their volatility, as discussed above, the FBAs have proposed removing from regulatory capital most of the GAAP capital inflation caused by gain-on-sale accounting by deducting the residual interests in computing regulatory capital.

While this may, at least temporarily, mitigate the residuals problem as it relates to capital, this situation illustrates the broader issue that accounting changes can sometimes have far-reaching, and troublesome implications for bank regulation. We therefore recommend that prior to the issuance of a SFAS that has a potential major impact on banks and thrifts, the FASB should conduct a formal impact study, and consult with the FBAs regarding the potential impact of the change or revision.

## **B. External Auditor Issues**

### **1. Auditor Independence**

Under relevant professional standards, an external auditor must be independent, both in fact and in appearance. Some believe that this independence becomes impaired where an auditor provides certain “nonaudit” services (such as consulting) to an audit client. In recognition of this, last year the SEC revised its independence rules to limit an auditor’s ability to provide “nonaudit” services to an audit client.

The SEC's revision did not, however, delineate what appropriately falls within the purview of "audit" services. Thus, independence issues remain with respect to services that are labeled as "audit" services by an auditor. In the context of securitizations, auditors typically provide valuation services. Such services may include advising on the methodologies and assumptions for estimating the fair value of residual interests. Quite often, such services are provided by members of the audit team, and are considered "audit" services; nevertheless, the audit team will then audit the valuation, i.e., the results of their own work. It is not farfetched to question whether the auditor's independence becomes impaired where the auditor provides valuation services in connection with an audit, regardless of how the services are characterized.

In 1999, the audit profession's Independence Standards Board ("ISB") recognized this threat to independence, and issued an interpretation that limited the provision of valuation services, but only as it relates to derivative instruments. The AICPA and SEC should be encouraged to further strengthen auditor independence rules to prevent auditors from providing valuation services to audit clients, even if those services are considered "audit."

Congress or the FBAs could also encourage the AICPA and SEC to establish an "external auditor rotation" requirement, or at least as to institutions of

significant size. This would require that an external audit firm and/or engagement partner limit their relationship with an audit client to a specified number of years (for example, 3 to 4 years). While we understand the economic arguments in opposition to this requirement, its adoption would result in a periodic “fresh look” at the institution from an audit perspective, to the benefit of investors and regulators.

## **2. External Auditor Training and Experience**

The accounting, reporting, and regulatory capital treatment for securitizations and residual interests is highly complex, both because of the complexity of the instruments themselves and because of the accounting and reporting requirements. It is imperative that key members of the external audit team, including the engagement partner, have sufficient training and experience in this area. In addition, it is important that a second partner with sufficient training and experience in the area perform a review. Unfortunately, over the last several years, we have seen situations where this level of training and experience was lacking. For those institutions, this has resulted in significant unfavorable adjustments to reported income, GAAP capital, and regulatory capital.

The most obvious way to address this problem is to encourage the AICPA and major external audit firms to strengthen their requirements for training and

experience. Key members of an audit team, including the engagement partner and the review partner, should be trained in and experienced with all of the financial complexities anticipated in an engagement. Where unanticipated issues arise, an audit firm should make arrangements to bring in the necessary experts to complete a review or indicate to the institution that it is unable to do so.

### **3. Resolution of Accounting Disputes**

The objectives of an external audit and an examination are very different. The objective of an audit is for the auditor to issue an opinion that the financial statements of the audit client are prepared in accordance with GAAP. That is, the sole purpose of the audit is to opine on the institution's financial statements.

By contrast, an examination is much more comprehensive. The objective of an examination is for the examiner to develop conclusions and recommendations regarding the safety and soundness of the institution. The examiner evaluates the institution's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. But in doing so, the examiner, who is usually not an accountant, relies, in many aspects of the exam, on the auditor's certification of the financial statements. This includes items such as the valuation of assets, which may involve, for example, loan loss allowances or residual interests.

An institution that receives a “clean” opinion from its external auditor could receive an examination report in which the examiner concludes that the institution is operating in an unsafe and unsound manner, for example because of operational or systems problems, poor underwriting, or capital not commensurate with the institution’s risk profile. The examiner could recommend major changes at the institution or prospective enforcement actions.

Management has primary responsibility for an institution’s financial statements, including external financial statements (including Call Reports and TFRs) and financial statements included in audit reports. When there is disagreement between institution management and an examiner on an accounting issue with a significant potential adverse impact on the institution, most often the external auditor, as an expert, is asked to support management’s position. When this happens at an OTS-regulated institution, the OTS Regional Accountant, and sometimes the OTS Chief Accountant, works with the examiner to resolve the dispute. Unfortunately, this process sometimes takes several months or longer. During this time, the institution’s regulatory reports may not reflect the adjustment that could result from a resolution unfavorable to the institution. As a result, there may be a delay in certain supervisory actions, pending resolution of the issue.

To get at this problem, we recommend that Congress enact legislation providing that a federal bank regulator may issue an “accounting dispute letter,” starting a 60-day clock for resolution of the dispute, if the dispute could result in a lower PCA capital category for the institution. If there is no resolution at the close of this 60-day time period, the regulator’s position will be adopted for regulatory accounting purposes including, in particular, the Prompt Corrective Action provisions of Section 38 of the FDIA. The provision could be either an amendment to PCA or could stand alone. While this may seem extreme, we believe it will be used judiciously to force resolution only in those cases in which delay and intransigence, rather than legitimate policy disputes, are at issue.

## **V. Prompt Corrective Action<sup>9</sup>**

Ten years ago, Congress enacted Section 38 of the Federal Deposit Insurance Act (“FDIA”) — better known as Prompt Corrective Action (“PCA”). PCA was intended to give the FBAs the tools to minimize the potential cost to the deposit insurance funds of troubled institutions and ensure that the regulators not only could, but would, act quickly. Under PCA, capital is the key factor in determining an institution’s condition. As an institution’s capital condition deteriorates, regulators can use increasingly restrictive tools, including closing the institution, to avert or stem potential losses to the deposit insurance fund.

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<sup>9</sup> See also the discussion of resolution of accounting disputes, above.



At the same time PCA was enacted, Congress added a new Section 39 to the FDIA to address the full panoply of non-capital related safety and soundness related management and operational standards. That new authority authorized the FBAs to establish those standards, require institutions not in compliance with those standards to submit a plan showing how they would attain compliance, and take actions against and impose restrictions on institutions failing to submit or implement an acceptable plan.

PCA never contemplated that every institution subject to a PCA directive would be closed or that there would never be any loss to the insurance fund. The intent was to ensure early regulatory action and impose escalating restrictions upon institutions as their capital levels declined so that any eventual closure would result in smaller losses to the deposit insurance fund. The operational and managerial standards implemented under Section 39 were intended to serve similar goals for safety and soundness issues not necessarily involving capital.

In many ways, PCA has served its intended purposes well. OTS has issued 50 PCA Directives to 47 different institutions since 1992; only 8 of the 47 institutions involved failed. We have one PCA Directive outstanding. The remaining 38 institutions were restored to health, voluntarily liquidated, or eventually merged or sold to another institution—in all cases with no loss to the

deposit insurance fund. With respect to the three institutions other than Superior that were placed into receivership after the Resolution Trust Corporation (“RTC”) ceased its operations, PCA helped OTS impose appropriate limits on the troubled institution and substantially shrink its eventual cost to the deposit insurance fund. None resulted in a material loss to the fund. OTS used PCA in attempting to resolve the problems at Superior, and the institution shank by about 15% in its final six months, including the roll-off of more than \$120 million in insured brokered deposits. Nevertheless, there will likely be material loss to the deposit insurance fund.

We have used our authority under Section 39 and our implementing regulations at 12 CFR Part 570 more frequently than PCA in recent years, especially since directives under that authority worked effectively in the context of Y2K. OTS has issued 32 notices under Part 570, half of them related to Y2K. Other than Superior and Oceanmark<sup>10</sup>, none of the institutions has failed.

#### **A. Timing Issues with the PCA Process**

PCA was not intended to deal with catastrophic events – such as a liquidity crisis or a loss of market confidence – but with stemming the deterioration of an

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<sup>10</sup> Oceanmark FSB, failed in 1999, with a current estimated loss to the SAIF of \$620, 000. The Part 570 notice in that case related to Y2K, and had no bearing on the failure. A PCA directive was also issued to Oceanmark.

institution's capital position over time. PCA contains provisions allowing for downgrades in PCA categories based upon non-capital related safety and soundness concerns. However, the required hearing process involved with a downgrade and the availability of non-PCA enforcement tools, including the safety and soundness tools of Section 39, have meant that the downgrade provision for non-capital factors has been used only once by a FBA.

Congress may wish to reexamine how the safety and soundness measures of section 39 of the Federal Deposit Insurance Act interact with the PCA provisions under section 38. Both sections anticipate the passage of a certain amount of time as the regulators require a plan and the institution prepares and presents a satisfactory plan addressing the regulators' concerns. In the case of Superior, OTS used both tools because at the outset the institution's reported capital levels did not trigger the PCA process. However, the negotiations over the institution's condition and what then would be an acceptable capital or safety and soundness plan caused considerable delays under both provisions.

## **B. Including a Risk-Based Capital Measure in the PCA Critically Undercapitalized Category**

Including a risk-based capital measure in the PCA critically undercapitalized level would allow regulators to address serious off-balance sheet risks. Certain risks embedded in an institution's portfolio, such as those presented by securitizations, may not be adequately reflected in GAAP total assets and resulting tangible equity levels. In the event an institution becomes undercapitalized on a risk basis, the institution would not fall into the critically undercapitalized PCA category absent the availability of a risk-based capital measure. All of the other PCA categories have a risk-based capital component to address these risks. We believe such a measure is increasingly important as more and more institutions engage in higher levels of securitizations and other off-balance sheet activities.

The FBAs can address some of these concerns through rulemaking, but statutory authority that recognizes that off-balance sheet type risks may be serious enough to warrant steps that includes potentially closing an institution would be very helpful.

## **VI. Interagency Coordination Issues**

An issue that has generated significant interest in the context of Superior is the extent of coordination between OTS and the FDIC in addressing problems at the institution during the last several years. As I noted at the outset of my statement, there were occasional disagreements in judgment between OTS and the FDIC about the handling of Superior. But these had little, if any, bearing on the failure of Superior.

In particular, I believe it is unlikely that the addition of one FDIC examiner to OTS' January 1999 examination team would have prevented Superior's failure or materially reduced SAIF losses from the failure. Unfortunately, this is impossible to prove. OTS had a fully staffed, on-site examination in January 1999, and we shared all of our work papers and examination materials with the FDIC during this process. Based on our work papers, the FDIC issued Superior a composite CAMELS rating of "3," which was lower than our "2" composite rating.

While individuals from our respective agencies may disagree with each other at times, there is every incentive for the FBAs to work together and, particularly, to coordinate and cooperate with the FDIC to address problem institutions. There is definitely benefit in having two regulators instead of one

working on the same problem. In fact, this was very much the experience between OTS and the FDIC in the handling of Superior. In numerous instances, issues arose in which a joint OTS-FDIC response provided not only the best answer, but also the strength of a joint determination. Moreover, the healthy tension between the primary regulator and the FDIC aids in accomplishing the best result for the financial services system and the deposit insurance funds: a private sector solution where feasible and a least-cost liquidation, with pre-failure shrinkage, where not.

**A. Coordination with the FDIC: the Role of the Deposit Insurer as  
Back-up Regulator**

The FDIC has served as back-up regulator to OTS for the oversight of thrift institutions since the enactment of FIRREA in 1989. The relationship between the agencies and their respective industry oversight roles have evolved during the last 12 years. While the FDIC initially conducted separate exams for a large portion of OTS-regulated thrifts, by 1995 this duplication of regulatory oversight was viewed as counter-productive. As a result, both agencies agreed upon a protocol that guaranteed FDIC an on-site exam presence for troubled institutions but required some level of justification to go on-site for non-troubled institutions. The same protocol applies to the FDIC's back-up role for national banks regulated by OCC and state member banks regulated by the FRB.

Since March 1995, FDIC has participated on-site in 74 OTS exams. Under the interagency protocol, disputes between the FDIC and another FBA regarding FDIC exam participation are to be resolved by the FDIC Board. Since I joined the FDIC Board in October 1997, no cases have been submitted to the FDIC Board for consideration. All requests for exam participation have been worked out on an informal basis, mostly through the respective agency's regional offices.

Moreover, I have informed OTS's Regional Directors that they are not to deny any requests by the FDIC for on-site access; such a denial can only be made by me or my Deputy. Despite a general sense that the current arrangement has handled most circumstances, we believe it would be appropriate for all the banking agencies, including the Federal Reserve Board, to revisit the general approach and mechanics of FDIC on-site participation in exams of institutions for which it is not the primary federal regulator.

Without waiting for the broader review, we are looking internally at how to make FDIC participation more productive. The operational details of coordinating FDIC exam participation are determined at the regional level and can take different forms. For example, we may divide the work, or the FDIC may simply review and assess work performed by OTS examiners. However, in all cases, the exam report is prepared by OTS, sent to the FDIC for review, and then issued by OTS.

The FDIC will usually prepare an internal report and provide it to OTS. The FDIC does not provide any direct written communication to the thrift as a result of the exam participation. And, they do not jointly sign the OTS exam report. This can result in some counter-productive differences in the timing of each agency's report. OTS adheres to a very strict timeframe on transmission of the report to the institution in order to promote timely resolution of any deficiencies detailed in the report. Since the FDIC report is not transmitted to the thrift, the same type of time pressures are not present.

Differences in the timing of exam report completion can create difficulties for both the institution and the regulators when there are divergent conclusions. Once the on-site review has been completed, it is more difficult to resolve these interagency differences. In order to remedy this shortcoming we are committed to developing a procedure that will result in the resolution of any differences in a timely manner so that the agencies can present a unified and complete regulatory position in the report of exam and, where appropriate, quickly move to implementation of any enforcement action.

On-site FDIC exam participation tends to receive the bulk of the attention when addressing the FDIC's role as back-up regulator. However, for the vast majority of thrifts the FDIC fulfills their back-up role through off-site analysis.



This process tends to operate very successfully without much fanfare. Throughout the year FDIC case managers review and analyze a myriad of both public and private information on OTS-regulated thrifts.

We are continually working to provide the FDIC easy access to institution-specific information. The FDIC has direct access to institution-specific financial data through our internal reporting systems, and we provide the FDIC with monitoring information on a quarterly basis. Unless the OTS is otherwise directed by the FDIC, the FDIC regional office receives the draft exam report on every one of our institutions ten days before it is finalized, so any concerns the FDIC might have can be resolved or added before the report is transmitted to the institution. The number of interagency disputes that arise from this process is small and we are jointly working toward more timely recognition and resolution of differences, particularly rating differences.

## **B. Streamlining Interagency Coordination Processes**

The final topic I want to cover is the issue of broader interagency coordination. To the extent regulations could have prevented the Superior failure, our inability to move more quickly on both the recourse and the residual rules has to be tagged as part of the problem. Like more effective boards and management,

this one is hard to legislate. This is largely an area where the regulators have to have the will to improve. And I firmly believe that it can only be done by more frequent informal, but agenda-driven, meetings directly among the principals. There have been various attempts at this during my four years as OTS Director—the regulators’ breakfasts, lunches after FDIC board meetings, regular and not-so-regular bilateral meetings between various combinations of principals—but none have been sustained or particularly successful. I discussed this issue with Chairman Powell over breakfast two weeks ago, and he was very eager to try again.

We also need to do a better job of encouraging the staff to bring disputes to the principals earlier in the process. Like all staffs, ours have a tendency to want to try to solve problems themselves, in part out of respect for the principals, but I suspect in part out of a concern that the principals won’t really understand what’s at issue. At OTS, our small size and flat structure helps me break this down, but we’re certainly far from perfect. The principals themselves need to do a better job of forcing the issue.

Finally, we need to do a better job of working together across agencies. We already have a series of interagency groups or committees that regularly exchange information on problem institutions or specialty areas such as securitization or capital market activities. We need to add more cross-training, more work on each

other's examinations, perhaps details into other agencies (although of course each agency is concerned that the other will poach its best people). If we understood each others' perspectives better at all levels, we'd not only do a better job, we'd probably do it more efficiently.

## **VII. Conclusion**

I have spent the bulk of this testimony on suggestions about how to improve the regulatory process, including the role of accountants, that relate to a series of issues that all seem to have come together in the failure of Superior Bank. And I do think there is room for improvement. However, I think it's useful to close with the observation that regulatory action can only go so far: the ultimate responsibility for the success or failure of any institution rests on those who own, operate and run the institution.