FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20434

Office of Audits
Office of Inspector General

DATE: January 22, 1999

MEMORANDUM TO: James L. Sexton, Director
Division of Supervision

FROM: David H. Loewenstein
Assistant Inspector General

SUBJECT: *Material Loss Review – The Failure of BestBank, Boulder, Colorado*
(Audit Report No. 99-005)

In accordance with section 38(k) of the Federal Deposit Insurance Act (FDI Act), the Office of Inspector General (OIG) conducted a material loss review of the failure of BestBank, Boulder, Colorado, to determine the causes of the bank's failure and to evaluate the FDIC's supervision of the bank. BestBank was closed on July 23, 1998 with total assets of $314 million. At the time of closure, the FDIC estimated that the Bank Insurance Fund (BIF) would incur a loss of $28 million. The estimated loss was raised to $171.6 million as of December 31, 1998.

OVERVIEW

BestBank was closed by the Colorado State Banking Board in July 1998 after FDIC and Colorado Division of Banking (State) examiners detected losses of $134 million in the bank's unsecured subprime credit card accounts. These accounts were established starting in 1996 through telemarketing efforts targeting potential borrowers with tarnished credit histories. The telemarketed package included a travel club membership, which provided an option to purchase a cruise vacation, along with other offers and discounts. Those individuals expressing an interest in the credit card submitted an application and a $20 application fee. Upon approval, the credit card account was established with a $600 credit limit and an initial charge of $543 to cover the $498 cost of the travel package and a $45 annual fee. Although BestBank provided the funds for these accounts, each credit card was set up, managed, and accounted for outside of the bank by Century Financial Group, Inc., formerly known as Century Financial Services, Inc. (Century), and its affiliated companies.

The plan was highly successful in terms of volume. More than 500,000 new cards were issued and BestBank's assets grew 648 percent, from $42 million as of mid-1996 to $314 million at closing. Most of these assets, however, were amounts owed by the subprime credit card holders. During this time, both the chief executive officer (CEO) and the president of BestBank benefited from multi-million dollar bonuses that were tied to the growth of these accounts and the increased revenues from new account fees. Meanwhile, Century and its affiliates continued to benefit from the costs and fees charged to the new accountholders. This arrangement flourished for the 2-year period immediately prior to the bank's closing.

Unsecured subprime accounts usually have high delinquency rates, requiring a bank to set aside sufficient funds to cover potential losses. BestBank's delinquency rates were reported as very high beginning in the fall of 1996. At that time, Century modified the agreement with BestBank to repurchase delinquent accounts more quickly. This modified arrangement reduced the delinquency ratio during the October 1996 examination. Subsequently, FDIC and State examiners became suspicious about the continuing low delinquency rates. However, beginning with the October 1996 examination, BestBank officials impeded the examiners' access to bank records and staff. The FDIC did not obtain access to records supporting financial statements on Century until 1998. While the examiners were not certain that Century had sufficient resources to cover potential future losses, they relied on the fact that Century had been repurchasing delinquent accounts as agreed. All the while, the examiners were never fully aware of the toll the credit card operation was taking on the bank or of the losses that the credit card operation would later cause to the BIF.

Bank management's assertion that the bank could survive without Century's help prompted an FDIC and State joint visitation in May 1998. The examiners reviewed the assumptions included in the bank's cash flow projections and concluded that the assumptions were erroneous. Prior to a June 1998 joint examination, FDIC examiners researched several consumer complaints of improper credits appearing on the accounts. The examiners found that the low delinquency rates were the result of Century's application of $20 "credits" to 368,892 delinquent accounts without actual payments from the borrowers. These accounts represented 74 percent of the total active subprime credit card travel accounts, with an outstanding balance of $179.6 million. According to the June 1998 joint examination report, the application of the $20 credits was an apparent attempt to make these accounts appear current, precluding the need for Century to repurchase these accounts. After the examiners determined that the bank did not have sufficient funds to absorb the estimated losses from these delinquencies and that Century did not have the financial capability to repurchase the delinquent accounts, the Colorado State Banking Board closed the bank.

As a result of the losses associated with BestBank and the credit card operation, the FDIC has estimated that the loss to the BIF will be at least $171.6 million. In connection with the credit card program, there are allegations of potential fraudulent activities involving BestBank and Century. These allegations are beyond the scope of this material loss review and are currently being pursued by the FDIC and federal law enforcement agencies.

Our report on BestBank is structured as follows:

- The **Background** section provides information on two of the principals of the bank, its chief executive officer and the president, and also recaps the examination history of the bank from 1992 – 1998 with emphasis on the proposed and actual enforcement actions related to those examinations.

- A separate section discusses our **Objectives, Scope, and Methodology** in conducting this review.

- The **Results of Audit** section summarizes our findings and recommendations.

- Our main discussion of BestBank is presented in **two major sections**. In the first section, we discuss **the causes of BestBank's failure** and show how the credit card travel program was structured and how it contributed to the bank's eventual ruin while at the same time enriching the bank's CEO and president. The second major section of our report addresses **the FDIC's supervision of BestBank**. This part of our report focuses on the obstacles faced by the FDIC examiners as they tried to conduct their examinations of the bank and assess the safety and soundness of the institution over a 3-year period. It also shows how the Division of Supervision (DOS) missed certain opportunities for timely and effective supervisory actions during that same timeframe and how various breakdowns in communication and coordination adversely impacted the examination process.

- Our report is presented in the context of a "lessons learned" for the Corporation. It contains **11 recommendations** designed to provide FDIC examiners (1) access to third-party servicers that have the ability to significantly affect the safety and soundness of an insured institution,   (2) unfettered access to bank employees and records during examinations, and (3) guidance for improving the examination process. Given that subprime lending activities are becoming increasingly prevalent in the banking industry today, examiners need complete access to pertinent records in order to successfully conduct their work.

- On December 11, 1998, we provided a draft report to DOS for review and comment. In its response dated January 14, 1999, DOS management stated that our draft report findings were fundamentally and substantially flawed due to a basic error in methodology and attribution. DOS believes that we do not adequately address the irregular activities at the bank and the bank's outside credit card servicer and therefore we do not recognize the reasons for the material loss to the BIF. We believe that irregular activities related to the failure of BestBank are clearly addressed in our report. Related law enforcement activities are ongoing; as such, it would be inappropriate to discuss specific information related to these activities in our report. DOS agreed with 3 of our 11 recommendations, disagreed with 1, but did not provide clear agreement or disagreement with the remaining 7 recommendations. We believe that implementing our recommendations will assist in preventing future losses, such as those at BestBank, and in improving the DOS examination process. Our evaluation of DOS's response is included in the **Corporation Comments and OIG Evaluation** section of this report. (DOS's response is included in its entirety in appendix D.)

- We also provided the draft report to the State, and the FDIC's Legal Division and Division of Compliance and Consumer Affairs (DCA). The State and the Legal Division elected not to provide a written response to be included in the report. DCA provided written comments on January 12, 1999 regarding DCA's role in the consumer complaint process (see appendix E). No changes were necessary based on DCA's comments.

- Our report also contains **appendix material** that provides more detail on key elements of our discussion.

- Due to the complexity of some of the issues presented, we have included a **glossary of terms** to ease readability.