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BANK REGULATION

Analysis of the Failure of Superior Bank, FSB, Hinsdale, Illinois

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Mr. Chairman and Members of the Committee:

We are pleased to be here to discuss our analysis of the failure of Superior Bank, FSB, a federally chartered savings bank located outside Chicago, ILL. Shortly after Superior Bank's closure on July 27, 2001, the Federal Deposit Insurance Corporation (FDIC) projected that the failure of Superior Bank would result in a $426 - $526 million loss to the deposit insurance fund.[1] The magnitude of the projected loss to the deposit insurance fund resulted in questions being raised by Congress and industry observers about what went wrong at Superior, how it happened, and what steps can be taken to reduce the likelihood of a similar failure.

Our testimony today (1) describes the causes of the failure of Superior Bank, (2) discusses whether external audits identified problems with Superior Bank, and (3) evaluates the effectiveness of federal supervision of Superior, including the coordination between the primary regulator—the Office of Thrift Supervision (OTS)—and the FDIC. Finally, we discuss the extent that issues similar to those associated with Superior's failure were noted in Material Loss Reviews conducted by inspectors general on previous bank failures.

Our testimony is based on our review of OTS and FDIC files for Superior Bank, including reports of on-site examinations of the bank and off-site monitoring and analysis, and interviews with OTS and FDIC officials, including officials in the Chicago offices who had primary responsibility for Superior Bank. The scope of our work on the conduct of Superior's external auditors was limited due to the ongoing investigation and potential litigation by FDIC and OTS on issues surrounding the failure of Superior Bank.

[1]The amount of the expected loss to the insurance fund is still in question. To settle potential claims, former co-owners of Superior entered into a settlement with FDIC and OTS in December 2001. The settlement calls for a payment to FDIC of $460 million, of which $100 million already has been paid. The remaining $360 million is to be paid over the next 15 years. The ultimate cost to the insurance fund will be determined by the proceeds that FDIC obtains from the sale of the failed institution's assets and other factors.

Summary

The key events leading to the failure of Superior Bank were largely associated with the business strategy adopted by Superior Bank's management of originating and securitizing subprime loans on a large scale. This strategy resulted in rapid growth and a high concentration of extremely risky assets. Compounding this concentration in risky assets was the failure of Superior Bank's management to properly value and account for the interests that it had retained in pooled home mortgages.

Superior Bank generated high levels of "paper profits" that overstated its capital levels. When federal regulators were finally able to get Superior Bank to apply proper valuation and reporting practices, Superior Bank became significantly undercapitalized. When the owners of Superior Bank failed to contribute additional capital, the regulators were forced to place Superior into receivership.

Superior's external auditor, Ernst & Young, also failed to detect the improper valuation of Superior's retained interests until OTS and FDIC insisted that the issue be reviewed by Ernst & Young's national office. As noted earlier, FDIC and OTS are investigating the role of the external auditor in Superior's failure, with an eye to potential litigation.

Federal regulators were clearly not effective in identifying and acting on the problems at Superior Bank early enough to prevent a material loss to the deposit insurance fund. OTS, Superior's primary supervisor, bears the main responsibility for not acting earlier. Superior may not have been a problem bank back in the mid-1990s, but the risks of its strategy and its exposure to revaluation of the retained interests merited more careful and earlier attention. FDIC was the first to recognize the problems in Superior's financial situation, although the problems had grown by the time that FDIC recognized them in late 1998.

Both agencies were aware of the substantial concentration of retained interests that Superior held, but the apparently high level of earnings, the apparently adequate capital, and the belief that the management was conservatively managing the institution limited their actions. Earlier response to the "concerns" expressed in examination reports dating to the mid-1990s may not have been sufficient to avoid the failure of the bank, but it likely would have prevented subsequent growth and thus limited the potential loss to the insurance fund.

Problems in communication between OTS and FDIC appear to have hindered a coordinated supervisory approach. FDIC has recently announced that it has reached agreement with the other banking regulators to establish a better process for determining when FDIC will use its authority to examine an insured institution. While GAO welcomes improvements in this area, neither OTS nor FDIC completely followed the policy in force during 1998 and 1999, when OTS denied FDIC's request to participate in the 1999 examination. Thus, following through on policy implementation will be as important as the design of improved policies for involving FDIC in future bank examinations.

Background

Superior Bank was formed in 1988 when the Coast-to-Coast Financial Corporation, a holding company owned equally by the Pritzker and Dworman families[2], acquired Lyons Savings, a troubled federal savings and loan association. From 1988 to 1992, Superior Bank struggled financially and relied heavily on an assistance agreement from the Federal Savings and Loan Insurance Corporation (FSLIC).[3] Superior's activities were limited during the first few years of its operation, but by 1992, most of the bank's problems were resolved and the effects of the FSLIC agreement had diminished. OTS, the primary regulator of federally chartered savings institutions, had the lead responsibility for supervising Superior Bank while FDIC, with responsibility to protect the deposit insurance fund, acted as Superior's backup regulator. By 1993, both OTS and FDIC had given Superior a composite CAMEL "2" rating[4] and, at this time, FDIC began to rely only on off-site monitoring of superior.

[2]The Pritzkers are the owners of the Hyatt Hotels, and the Dwormans are prominent New York real estate developers.

[3]This assistance agreement included capital protection provisions and called for reimbursement of expenses for collecting certain problem assets, payment of 22.5 percent of pretax net income to FSLIC, and payment of a portion of certain recoveries to the FSLIC. (In later years, there was a disagreement over certain provisions to the assistance agreement and lawsuits were filed.)

[4]OTS and the other regulators use the Uniform Financial Institution Rating System to evaluate a bank's performance. CAMEL is an acronym for the performance rating components: capital adequacy, asset quality, management administration, earnings, and liquidity. An additional component, sensitivity to market risk, was added effective January 1, 1997, resulting in the acronym CAMELS. Ratings are on a 1 to 5 scale with 1 being the highest, or best, score and 5 being the lowest, or worst, score.

In 1993, Superior's management began to focus on expanding the bank's mortgage lending business by acquiring Alliance Funding Company. Superior adopted Alliance's business strategy of targeting borrowers nationwide with risky credit profiles, such as high debt ratios and credit histories that included past delinquencies—a practice known as subprime lending. In a process known as securitization, Superior then assembled the loans into pools and sold interest in these pools—such as rights to principal and/or interest payments—through a trust to investors, primarily in the form of AAA-rated mortgage securities. To enhance the value of these offerings, Superior retained the securities with the greatest amount of risk and provided other significant credit enhancements for the less risky securities. In 1995, Superior expanded its activities to include the origination and securitization of subprime automobile loans.

In December 1998, FDIC first raised concerns about Superior's increasing levels of high-risk, subprime assets and growth in retained or residual interests. However, it was not until January 2000 that OTS and FDIC conducted a joint exam and downgraded Superior's CAMELS rating to a "4," primarily attributed to the concentration of residual interest holdings. At the end of 2000, FDIC and OTS noted that the reported values of Superior's residual interest assets were overstated and that the bank's reporting of its residual interest assets was not in compliance with the Statement of Financial Accounting Standards (FAS) No. 125. Prompted by concerns from OTS and FDIC, Superior eventually made a number of adjustments to its financial statements. In mid-February 2001, OTS issued a Prompt Corrective Action (PCA) notice to Superior because the bank was significantly undercapitalized. On May 24, OTS approved Superior's PCA capital plan. Ultimately, the plan was never implemented, and OTS closed the bank and appointed FDIC as Superior's receiver on July 27, 2001. (A detailed chronology of the events leading up to Superior's failure is provided in App. I.)

Causes of Superior Bank's Failure

Primary responsibility for the failure of Superior Bank resides with its owners and managers. Superior's business strategy of originating and securitizing subprime loans appeared to have led to high earnings, but more importantly its strategy resulted in a high concentration of extremely risky assets. This high concentration of risky assets and the improper valuation of these assets ultimately led to Superior's failure.

Concentration of Risky Assets

In 1993, Superior Bank began to originate and securitize subprime home mortgages in large volumes. Later, Superior expanded its securitization activities to include subprime automobile loans. Although the securitization process moved the subprime loans off its balance sheet, Superior retained the riskier interests in the proceeds from the pools of securities it established. Superior's holdings of this retained interest exceeded its capital levels going as far back as 1995.

Retained or residual interests[5] are common in asset securitizations and often represent steps that the loan originator takes to enhance the quality of the interests in the pools that are offered for sale. Such enhancements can be critical to obtaining high credit ratings for the pool's securities. Often, the originator will retain the riskiest components of the pool, doing so to make the other components easier to sell. The originator's residual interests, in general, will represent the rights to cash flows or other assets after the pool's obligations to other investors have been satisfied.

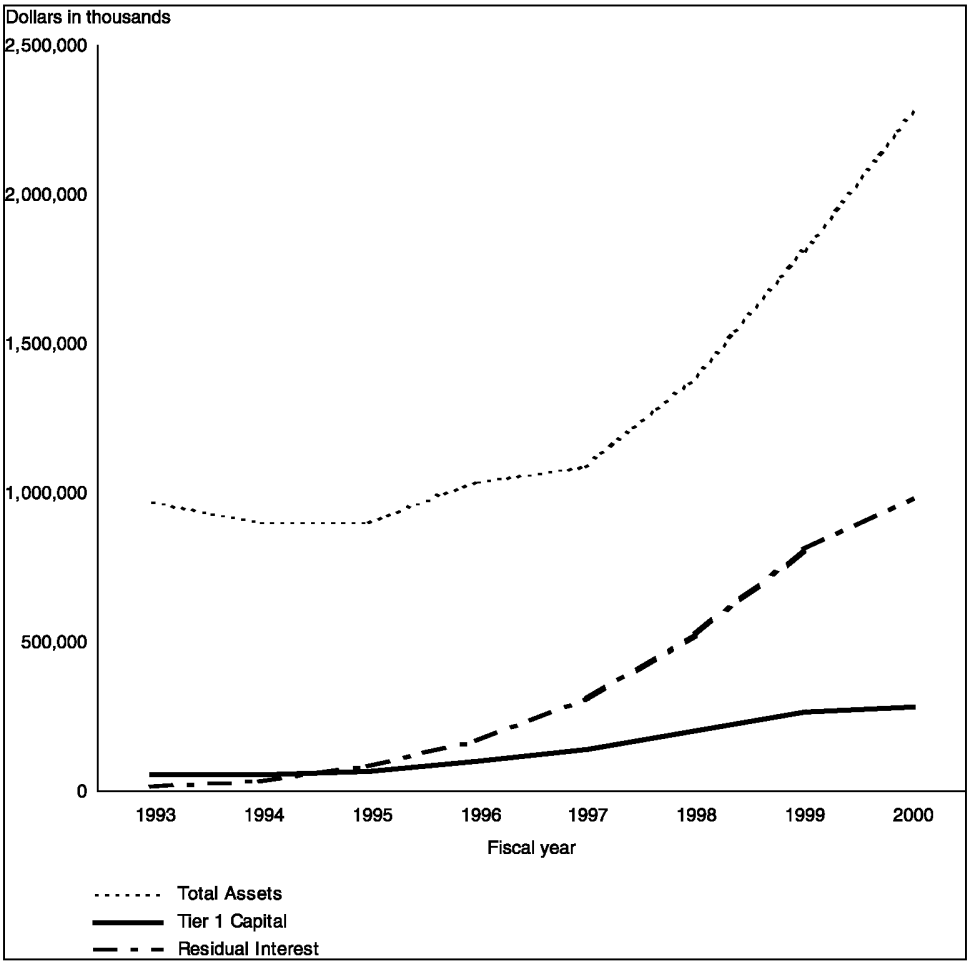
Overcollateralization assets are another type of residual interest that Superior held. To decrease risk to investors, the originator may overcollateralize the securitization trust that holds the assets and is responsible for paying the investors. An originator can overcollateralize by selling the rights to $100 in principal payments, for instance, while putting assets worth $105 into the trust, essentially providing a cushion, or credit enhancement, to help ensure that the $100 due investors is paid in event of defaults in the underlying pool of loans (credit losses). The originator would receive any payments in excess of the $100 interest that was sold to investors after credit losses are paid from the overcollateralized portion.

As shown in figure 1, Superior's residual interests represented approximately 100 percent of tier 1 capital on June 30, 1995.[6] By June 30, 2000, residual interest represented 348 percent of tier 1 capital. This level of concentration was particularly risky given the complexities associated with achieving a reasonable valuation of residual interests.

[5]These interests are known as residuals because they receive the last cash flows from the loans.

[6]Tier 1 capital consists primarily of tangible equity capital—equity capital plus cumulative preferred stock (including related surplus)—minus all intangible assets, except for some amount of purchased mortgage servicing rights.

Figure 1: Superior's Total Assets, Residuals, and Tier 1 Capital from 1993 to 2000



Note: Data are as of June 30 for each fiscal year shown.

Source: Superior Bank's financial statements and OTS.

Superior's practice of targeting subprime borrowers increased its risk. By targeting borrowers with low credit quality, Superior was able to originate loans with interest rates that were higher than market averages. The high interest rates reflected, at least in part, the relatively high credit risk associated with these loans. When these loans were then pooled and securitized, their high interest rates relative to the interest rates paid on the resulting securities, together with the high valuation of the retained interest, enabled Superior to record gains on the securitization transactions that drove its apparently high earnings and high capital. A significant amount of Superior's revenue was from the sale of loans in

these transactions, yet more cash was going out rather than coming in from these activities.

In addition to the higher risk of default related to subprime lending, there was also prepayment risk. Generally, if interest rates decline, a loan charging an interest rate that is higher than market averages becomes more valuable to the lender. However, lower interest rates could also trigger higher than predicted levels of loan prepayment—particularly if the new lower interest rates enable subprime borrowers to qualify for refinancing at lower rates. Higher-than-projected prepayments negatively impact the future flows of interest payments from the underlying loans in a securitized portfolio.

Additionally, Superior expanded its loan origination and securitization activities to include automobile loans. The credit risk of automobile loans is inherently higher than that associated with home mortgages, because these loans are associated with even higher default and loss rates. Auto loan underwriting is divided into classes of credit quality (most commonly A, B, and C). Some 85 percent of Superior Bank's auto loans went to people with B and C ratings. In Superior's classification system, these borrowers had experienced credit problems in the past because of unusual circumstances beyond their control (such as a major illness, job loss, or death in the family) but had since resolved their credit problems and rebuilt their credit ratings to a certain extent. As with its mortgage securitizations, Superior Bank was able to maintain a high spread between the interest rate of the auto loans and the yield that investors paid for the securities based on the pooled loans. However, Superior's loss rates on its automobile loans as of December 31, 1999 were twice as high as Superior's management had anticipated.

Valuation of Residual Interests

Superior Bank's business strategy rested heavily on the value assigned to the residual interests that resulted from its securitization activities. However, the valuation of residual interests is extremely complex and highly dependent on making accurate assumptions regarding a number of factors. Superior overvalued its residual interests because it did not discount to present value the future cash flows that were subject to credit losses. When these valuations were ultimately adjusted, at the behest of the regulators, the bank became significantly undercapitalized and eventually failed.

There are significant valuation issues and risks associated with residual interests. Generally, the residual interest represents the cash flows from

the underlying mortgages that remain after all payments have been made to the other classes of securities issued by the trust for the pool, and after the fees and expenses have been paid. As the loan originator, Superior Bank was considered to be in the "first-loss" position (i.e., Superior would suffer any credit losses suffered by the pool, before any other investor.) Credit losses are not the only risks held by the residual interest holder. The valuation of the residual interest depends critically on how accurately future interest rates and loan prepayments are forecasted. Market events can affect the discount rate, prepayment speed, or performance of the underlying assets in a securitization transaction and can swiftly and dramatically alter their value.

The Financial Accounting Standards Board (FASB) recognized the need for a new accounting approach to address innovations and complex developments in the financial markets, such as the securitization of loans. Under FAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,"[7] which became effective after December 31, 1996, when a transferor surrenders control over transferred assets, it should be accounted for as a sale. The transferor should recognize that any retained interest in the transferred assets should be reported in its statement of financial position based on the fair value. The best evidence of fair value is a quoted market price in an active market, but if there is no market price, the value must be estimated. In estimating the fair value of retained interests, valuation techniques include estimating the present value of expected future cash flows using a discount rate commensurate with the risks involved. The standard states that those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In 1999, FASB explained that when estimating the fair value for

[7]FAS No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, issued September 2000, replaced FAS No. 125.

retained interests used as a credit enhancement, it should be discounted from the date when it is estimated to become available to the transferor.[8]

Superior Bank did not properly value the residual interest assets it reported on its financial statements. Since those assets represented payments that were to be received in the future only after credit losses were reimbursed, they needed to be discounted at an appropriate risk-adjusted rate, in order to recognize that a promise to pay in the future is worth less than a current payment. Superior did not use discounting when valuing its residual interest related to overcollateralization. However, as a credit enhancement, the overcollateralized asset is restricted in use under the trust and not available to Superior until losses have been paid under the terms of the credit enhancement. The result was that Superior Bank reported assets, earnings, and capital that were far in excess of their true values. In addition, there were other issues with respect to Superior's compliance with FAS No. 125. When Superior finally applied the appropriate valuation techniques and related accounting to the residual interests in early 2001, at the urging of OTS, Superior was forced to take a write-off against its capital and became "significantly undercapitalized."

Regulators' Concerns About the Quality of the External Audit

Federal regulators now have serious concerns about the quality of Ernst & Young's audit of Superior Bank's financial statements for the fiscal year ending June 30, 2000. This audit could have highlighted the problems that led to Superior Bank's failure but did not. Regulators' major concerns related to the audit include (1) the inflated valuation of residual interest in the financial statements and (2) the absence of discussion on Superior's ability to continue in business in the auditor's report.

The accounting profession plays a vital role in the governance structure for the banking industry. In addition to bank examinations, independent certified public accountant audits are performed to express an opinion on the fairness of bank's financial statements and to report any material

[8]This concept is reiterated in FASB's *A Guide to Implemention of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers*, Issued July 1999 and revised September 1999. When estimating the fair value of credit enhancements (retained interest), the transferor's assumptions should include the period of time that its use of the asset is restricted, reinvestment income, and potential losses due to uncertainties. One acceptable valuation technique is the "cash out" method, in which cash flows are discounted from the date that the credit enhancement becomes available.

weaknesses in internal controls. Auditing standards require public accountants rendering an opinion on financial statements to consider the need to disclose conditions that raise a question about an entity's ability to continue in business. Audits should provide useful information to federal regulators who oversee the banks, depositors, owners, and the public. When financial audits are not of the quality that meets auditing standards, this undermines the governance structure of the banking industry.

Federal regulators believed that Ernst & Young auditors' review of Superior's valuation of residuals failed to identify the overvaluation of Superior's residual interests in its fiscal year 2000 financial statements. Recognizing a significant growth in residual assets, federal regulators performed a review of Superior's valuation of its residuals for that same year and found that it was not being properly reported in accordance with Generally Accepted Accounting Principles (GAAP). The regulators believed the incorrect valuation of the residuals had resulted in a significant overstatement of Superior's assets and capital. Although Ernst & Young's local office disagreed with the regulators findings, Ernst & Young's national office concurred with the regulators. Subsequently, Superior revalued these assets resulting in a $270 million write-down of the residual interest value. As a result, Superior's capital was reduced and Superior became significantly undercapitalized. OTS took a number of actions, but ultimately had to close Superior and appoint FDIC as receiver.

An FDIC official stated that Superior had used this improper valuation technique not only for its June 30, 2000, financial statements, but also for the years 1995 through 1999. To the extent that was true, Superior's earnings and capital were likely overstated during those years, as well. However, in each of those fiscal years, from 1995 through 2000, Superior received an unqualified, or "clean," opinion from the Ernst & Young auditors.

In Ernst & Young's audit opinion, there was no disclosure of Superior's questionable ability to continue as a going concern. Yet, 10 months after the date of Ernst & Young's audit opinion on September 22, 2000, Superior Bank was closed and placed into receivership. Auditing standards provide that the auditor is responsible for evaluating "whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time." This evaluation should be based on the auditor's "knowledge of relevant conditions and events that exist at or have occurred prior to the completion of fieldwork." FDIC officials believe that the auditors should have known about the potential valuation issues and should have evaluated the "conditions and events" relating to

Superior's retained interests in securitizations and the subsequent impact on capital requirements. FDIC officials also believe that the auditors should have known about the issues at the date of the last audit report, and there was a sufficient basis for the auditor to determine that there was "substantial doubt" about Superior's "ability to continue as a going concern for a reasonable period of time." Because Ernst & Young auditors did not reach this conclusion in their opinion, FDIC has expressed concerns about the quality of the audit of Superior's fiscal year 2000 financial statements.

FDIC has retained legal and forensic accounting assistance to conduct an investigation into the failure of Superior Bank. This investigation includes not only an examination of Superior's lending and investment practices but also a review of the bank's independent auditors, Ernst & Young. It involves a thorough review of the accounting firm's audit of the bank's financial statements and role as a consultant and advisor to Superior on valuation issues. The major accounting and auditing issues in this review will include (1) an evaluation of the over-collateralized assets valuation as well as other residual assets, (2) whether "going concern" issues should have been raised had Superior Bank's financials been correctly stated, and (3) an evaluation of both the qualifications and independence of the accounting firm. The target date for the final report from the forensic auditor is May 1, 2002. OTS officials told us that they have opened a formal investigation regarding Superior's failure and have issued subpoenas to Ernst & Young, among others.

Effectiveness of OTS and FDIC Supervision of Superior Bank

Our review of OTS's supervision of Superior Bank found that the regulator had information, going back to the mid-1990s, that indicated supervisory concerns with Superior Bank's substantial retained interests in securitized, subprime home mortgages and recognition that the bank's soundness depended critically on the valuation of these interests. However, the high apparent earnings of the bank, its apparently adequate capital levels, and supervisory expectations that the ownership of the bank would provide adequate support in the event of problems appear to have combined to delay effective enforcement actions. Problems with communication and coordination between OTS and FDIC also created a delay in supervisory response after FDIC raised serious questions about the operations of Superior. By the time that the PCA directive was issued in February 2001, Superior's failure was probably inevitable.

Weaknesses in OTS's Oversight of Superior

As Superior's primary regulator, OTS had the lead responsibility for monitoring the bank's safety and soundness. Although OTS identified many of the risks associated with Superior's business strategy as early as 1993, it did not exercise sufficient professional skepticism with respect to the "red flags" it identified with regards to Superior's securitization activities. Consequently, OTS did not fully recognize the risk profile of the bank and thus did not address the magnitude of the bank's problems in a timely manner. Specifically:

- OTS's assessment of Superior's risk profile was clouded by the bank's apparent strong operating performance and higher-than-peer leverage capital;
- OTS relied heavily on management's expertise and assurances; and
- OTS relied on the external audit reports without evaluating the quality of the external auditors' review of Superior's securitization activities.

OTS's Supervision of Superior was Influenced by its Apparent High Earnings and Capital Levels

OTS's ratings of Superior from 1993 through 1999 appeared to have been heavily influenced by Superior's apparent high earnings and capital levels. Beginning in 1993, OTS had information showing that Superior was engaging in activities that were riskier than those of most other thrifts and merited close monitoring. Although neither subprime lending nor securitization is an inherently unsafe or unsound activity, both entail risks that bank management must manage and its regulator must consider in its examination and supervisory activities. While OTS examiners viewed Superior Bank's high earnings as a source of strength, a large portion of these earnings represented estimated payments due sometime in the future and thus were not realized. These high earnings were also indicators of the riskiness of the underlying assets and business strategy. Moreover, Superior had a higher concentration of residual interest assets than any other thrift under OTS's supervision. However, OTS did not take supervisory action to limit Superior's securitization activities until after the 2000 examination.

According to OTS's Regulatory Handbook, greater regulatory attention is required when asset concentrations exceed 25 percent of a thrift's core capital.[9] As previously discussed, Superior's concentration in residual interest securities equaled 100 percent of tier 1 capital in June 30, 1995 and grew to 348 percent of tier 1 capital in June 30, 2000. However, OTS's

[9]Section 211, Asset Quality - Loan Portfolio Diversification, OTS Regulatory Handbook, January 1994.

examination reports during this period reflected an optimistic understanding of the implications for Superior Bank. The examination reports consistently noted that the risks associated with such lending and related residual interest securities were balanced by Superior's strong earnings, higher-than-peer leverage capital, and substantial reserves for loan losses. OTS examiners did not question whether the ongoing trend of high growth and concentrations in subprime loans and residual interest securities was a prudent strategy for the bank. Consequently, the CAMELS ratings did not accurately reflect the conditions of those components.

Superior's business strategy as a lender to high-risk borrowers was clearly visible in data that OTS prepared comparing it to other thrifts of comparable size. Superior's ratio of nonperforming assets to total assets in December 1998 was 233 percent higher than the peer group's median. Another indicator of risk was the interest rate on the mortgages that Superior had made with a higher rate indicating a riskier borrower. In 1999, over 39 percent of Superior's mortgages carried interest rates of 11 percent or higher. Among Superior's peer group, less than 1 percent of all mortgages had interest rates that high.

OTS's 1997 examination report for Superior Bank illustrated the influence of Superior's high earnings on the regulator's assessment. The 1997 examination report noted that Superior's earnings were very strong and exceeded industry averages. The report stated that the earnings were largely the result of large imputed gains from the sale of loans with high interest rates and had not been realized on a cash flow basis. Furthermore, the report recognized that changes in prepayment assumptions could negatively impact the realization of the gains previously recognized. Despite the recognition of the dependence of Superior's earnings on critical assumptions regarding prepayment and actual loss rates, OTS gave Superior Bank the highest composite CAMELS rating, as well as the highest rating for four of the six CAMELS components—asset quality, management, earnings, and sensitivity to market risk—at the conclusion of its 1997 examination.

OTS Relied on Superior's Management and Owners

OTS consistently assumed that Superior's management had the necessary expertise to safely manage the complexities of Superior's securitization activities. In addition, OTS relied on Superior's management to take the necessary corrective actions to address the deficiencies that had been identified by OTS examiners. Moreover, OTS expected the owners of Superior' to come to the bank's financial rescue if necessary. These critical assumptions by OTS ultimately proved erroneous.

From 1993 through 1999, OTS appeared to have had confidence in Superior's management's ability to safely manage and control the risks associated with its highly sophisticated securitization activities. As an illustration of OTS reliance on Superior's management assurances, OTS examiners brought to management's attention in the 1997 and 1999 examinations that underlying mortgage pools had prepayment rates exceeding those used in the revaluation. OTS examiners accepted management's response that the prepayment rates observed on those subpools were abnormally high when compared with historical experience, and that they believed sufficient valuation allowances had been established on the residuals to prevent any significant changes to capital. It was not until the 2000 examination, when OTS examiners demanded supporting documentation concerning residual interests, that they were surprised to learn that such documentation was not always available. OTS's optimistic assessment of the capability of Superior's management continued through 1999. For example, OTS noted in its 1999 examination report that the weaknesses it had detected during the examination were well within the board of directors' and management's capabilities to correct.

OTS relied on Superior Bank's management and board of directors to take the necessary corrective action to address the numerous deficiencies OTS examiners identified during the 1993 through 1999 examinations. However, many of the deficiencies remained uncorrected even after repeated examinations. For example, OTS expressed concerns in its 1994 and 1995 examinations about the improper inclusion of reserves for the residual interest assets in the Allowance for Loan and Lease Losses. This practice had the net effect of overstating the institution's total capital ratio. OTS apparently relied on management's assurances that they would take the appropriate corrective action, because this issue was not discussed in OTS's 1996, 1997, or 1999 examination reports. However, OTS discovered in its 2000 examination that Superior Bank had not taken the agreed-upon corrective action, but in fact had continued the practice. Similarly, OTS found in both its 1997 and 1999 examinations that Superior was underreporting classified or troubled loans in its Thrift Financial Reports (TFR). In the 1997 examination, OTS found that not all classified assets were reported in the TFR and obtained management's agreement to ensure the accuracy of subsequent reports. In the 1999 examination, however, OTS found that $43.7 million in troubled assets had been shown as repossessions on the most recent TFR, although a significant portion of these assets were accorded a "loss" classification in internal reports. As a result, actual repossessions were only $8.4 million. OTS conducted a special field visit to examine the auto loan operations in October 1999, but

the review focused on the classification aspect rather than the fact that management had not been very conservative in charging-off problem auto credits, as FDIC had pointed out.

OTS also appeared to have assumed that the wealthy owners of Superior Bank would come to the bank's financial rescue when needed. The 2000 examination report demonstrated OTS's attitude towards its supervision of Superior by stating that failure was not likely due to the institution's overall strength and financial capacity and the support of the two ownership interests comprised of the Alvin Dworman and Jay Pritzker families.

OTS's assumptions about the willingness of Superior's owners not to allow the institution to fail were ultimately proven false during the 2001 negotiations to recapitalize the institution. As a result, the institution was placed into receivership.

OTS Placed Undue Reliance on the External Auditors

OTS also relied on the external auditors and others who were reporting satisfaction with Superior's valuation method. In previous reports, GAO has supported having examiners place greater reliance on the work of external auditors in order to enhance supervisory monitoring of banks. Some regulatory officials have said that examiners may be able to use external auditors' work to eliminate certain examination procedures from their examinations—for example, verification or confirmation of the existence and valuation of institution assets such as loans, derivative transactions, and accounts receivable. The officials further said that external auditors perform these verifications or confirmations routinely as a part of their financial statement audits. But examiners rarely perform such verifications because they are costly and time consuming.

GAO continues to believe that examiners should use external auditors' work to enhance the efficiency of examinations. However, this reliance should be predicated on the examiners' obtaining reasonable assurance that the audits have been performed in a quality manner and in accordance with professional standards. OTS's Regulatory Handbook recognizes the limitations of examiners' reliance on external auditors,[10] noting that examiners "may" rely on an external auditor's findings in low-risk areas. However, examiners are expected to conduct more in-depth reviews of the external auditor's work in high-risk areas. The handbook also suggests

[10]Section 350, Independent Audit, OTS Regulatory Handbook, January 1994.

that a review of the auditor's workpapers documenting the assumptions and methodologies used by the institution to value key assets could assist examiners in performing their examinations.

In the case of Superior Bank, the external auditor, Ernst & Young, one of the "Big Five" accounting firms,[11] provided unqualified opinions on the bank's financial statements for years. In a January 2000 meeting with Superior Bank's Audit Committee to report the audit results for the fiscal year ending June 30, 1999, Ernst & Young noted that "after running their own model to test the Bank's model, Ernst & Young believes that the overall book values of financial receivables as recorded by the Bank are reasonable considering the Bank's overall conservative assumptions and methods." Not only did Ernst & Young not detect the overvaluation of Superior's residual interests, the firm explicitly supported an incorrect valuation until, at the insistence of the regulators, the Ernst &Young office that had conducted the audit sought a review of its position on the valuation by its national office. Ultimately, it was the incorrect valuation of these assets that led to the failure of Superior Bank. Although the regulators recognized this problem before Ernst & Young, they did not do so until the problem was so severe that the bank's failure was inevitable.

Although FDIC Was First to Raise Concerns About Superior, Problems Could Have Been Detected Sooner

FDIC raised serious concerns about Superior's operations at the end of 1998 based on its off-site monitoring and asked that an FDIC examiner participate in the examination of the bank that was scheduled to start in January 1999. At that time, OTS rated the institution a composite "1." Although FDIC's 1998 off-site analysis began the identification of the problems that led to Superior's failure, FDIC had conducted similar off-site monitoring in previous years that did not raise concerns.

During the late 1980s and early 1990s, FDIC examined Superior Bank several times because it was operating under an assistance agreement with FSLIC. However, once Superior's condition stabilized and its composite rating was upgraded to a "2" in 1993, FDIC's review was limited to off-site monitoring. In 1995, 1996, and 1997, FDIC reviewed the annual OTS examinations and other material, including the bank's supervisory filings and audited financial statements. Although FDIC's internal reports noted

[11]The "Big Five" accounting firms are Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP.

that Superior's holdings of residual assets exceeded its capital, they did not identify these holdings as concerns.

FDIC's interest in Superior Bank was heightened in December 1998 when it conducted an off-site review, based on September 30, 1998 financial information. During this review, FDIC noted—with alarm—that Superior Bank exhibited a high-risk asset structure. Specifically, the review noted that Superior had significant investments in the residual values of securitized loans. These investments, by then, were equal to roughly 150 percent of its tier 1 capital. The review also noted that significant reporting differences existed between the bank's audit report and its quarterly financial statement to regulators, that the bank was a subprime lender, and had substantial off-balance sheet recourse exposure.

As noted earlier, however, the bank's residual assets had been over 100 percent of capital since 1995. FDIC had been aware of this high concentration and had noted it in the summary analyses of examination reports that it completed during off-site monitoring, but FDIC did not initiate any additional off-site activities or raise any concerns to OTS until after a 1998 off-site review that it performed. Although current guidance would have imposed limits at 25 percent, there was no explicit direction to the bank's examiners or analysts on safe limits for residual assets. However, Superior was clearly an outlier, with holdings substantially greater than peer group banks.

In early 1999, FDIC's additional off-site monitoring and review of OTS's January 1999 examination report—in which OTS rated Superior a "2"—generated additional concerns. As a result, FDIC officially downgraded the bank to a composite "3" in May 1999, triggering higher deposit insurance premiums under the risk-related premium system. According to FDIC and OTS officials, FDIC participated fully in the oversight of Superior after this point.

Poor OTS-FDIC Communication Hindered a Coordinated Supervisory Strategy

Communication between OTS and FDIC related to Superior Bank was a problem. Although the agencies worked together effectively on enforcement actions (discussed below), poor communication seems to have hindered coordination of supervisory strategies for the bank.

The policy regarding FDIC's participation in examinations led by other federal supervisory agencies was based on the "anticipated benefit to FDIC in its deposit insurer role and risk of failure the involved institution poses to the insurance fund."[12] This policy stated that any back-up examination activities must be "consistent with FDIC's prior commitments to reduce costs to the industry, reduce burden, and eliminate duplication of efforts."

In 1995, OTS delegated to its regional directors the authority to approve requests by FDIC to participate in OTS examinations.[13] The memorandum from OTS headquarters to the regional directors on the FDIC participation process states that:

> "The FDIC's written request should demonstrate that the institution represents a potential or likely failure within a one year time frame, or that there is a basis for believing that the institution represents a greater than normal risk to the insurance fund and data available from other sources is insufficient to assess that risk."

As testimony before this committee last fall documented, FDIC's off-site review in 1998 was the first time that serious questions had been raised about Superior Bank's strategy and finances. As FDIC Director John Reich testified,

> "The FDIC's off-site review noted significant reporting differences between the bank's audit report and its quarterly financial statement to regulators, increasing levels of high-risk, subprime assets, and growth in retained interests and mortgage servicing assets."[14]

Because of these concerns, FDIC regional staff called OTS regional staff and discussed having an FDIC examiner participate in the January 1999

[12]Each federal banking agency is responsible for conducting examinations of the depository institutions under its jurisdiction. FDIC is the federal banking regulator responsible for examining federally insured state-chartered banks that are not members of the Federal Reserve System. In addition, FDIC may conduct a special examination of any insured depository institution whenever the FDIC's Board of Directors decides that the examination is necessary to determine the condition of the institution for insurance purposes. 12 U.S.C. §1820(b) (2000).

[13]OTS Memorandum to Regional Directors from John F. Downey, Director of Supervision, Regarding FDIC Participation on Examinations, April 5, 1995.

[14]Statement of John Reich, Acting Director, Federal Deposit Insurance Corporation, on the Failure of Superior Bank, FSB, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 11, 2001.

examination of Superior Bank. OTS officials, according to internal e-mails, were unsure it they should agree to FDIC's participation. Ongoing litigation between FDIC and Superior and concern that Superior's "poor opinion" of FDIC would "jeopardize [OTS's] working relationship" with Superior were among the concerns expressed in the e-mails. OTS decided to wait for a formal, written FDIC request to see if it "convey[ed] a good reason" for wanting to join in the OTS examination.

OTS and FDIC disagree on what happened next. FDIC officials told us that they sent a formal request to the OTS regional office asking that one examiner participate in the next scheduled examination but did not receive any response. OTS officials told us that they never received any formal request. FDIC files do contain a letter, but there is no way to determine if it was sent or lost in transit. This letter, dated December 28, 1998, noted areas of concern as well as an acknowledgment that Superior's management was well regarded, and that the bank was extremely profitable and considered to be "well-capitalized."

OTS did not allow FDIC to join their exam, but did allow its examiners to review work papers prepared by OTS examiners. Again, the two agencies disagree on the effectiveness of this approach. FDIC's regional staff has noted that in their view this arrangement was not satisfactory, since their access to the workpapers was not sufficiently timely to enable them to understand Superior's operations. OTS officials told us that FDIC did not express any concerns with the arrangement and were surprised to receive a draft memorandum from FDIC's regional office proposing that Superior's composite rating be lowered to a "3," in contrast to the OTS region's proposed rating of "2."

However, by September 1999, the two agencies had agreed that FDIC would participate in the next examination, scheduled for January 2000.

In the aftermath of Superior's failure and the earlier failure of Keystone National Bank, both OTS and FDIC have participated in an interagency process to clarify FDIC's role, responsibility, and authority to participate in examinations as the "backup" regulator. In both bank failures, FDIC had asked to participate in examinations, but the lead regulatory agency (OTS in the case of Superior and the Office of the Comptroller of the Currency in the case of Keystone) denied the request. On January 29, 2002, FDIC announced an interagency agreement that gives it more authority to enter banks supervised by other regulators.

While this interagency effort should lead to a clearer understanding among the federal bank supervisory agencies about FDIC's participation in the examinations of and supervisory actions taken at open banks, it is important to recognize that at the time that FDIC asked to join in the 1999 examination of Superior Bank, there were policies in place that should have guided its request and OTS's decision on FDIC's participation. As such, how the new procedures are implemented is a critical issue. Ultimately, coordination and cooperation among federal bank supervisors depend on communication among these agencies, and miscommunication plagued OTS and FDIC at a time when the two agencies were just beginning to recognize the problems that they confronted at Superior Bank.

The Effectiveness of Enforcement Actions Was Limited

As a consequence of the delayed recognition of problems at Superior Bank, enforcement actions were not successful in containing the loss to the deposit insurance fund. Once the problems at Superior Bank had been identified, OTS took a number of formal enforcement actions against Superior Bank starting on July 5, 2000. These actions included a PCA directive.

There is no way to know if earlier detection of the problems at Superior Bank, particularly the incorrect valuation of the residual assets, would have prevented the bank's ultimate failure. However, earlier detection would likely have triggered enforcement actions that could have limited Superior's growth and asset concentration and, as a result, the magnitude of the loss to the insurance fund.

Table 2 describes the formal enforcement actions. (Informal enforcement actions before July 2000 included identifying "actions requiring board attention" in the examination reports, including the report dated Jan. 24, 2000.) The first action, the "Part 570 Safety and Soundness Action,"[15] followed the completion of an on-site examination that began in January 2000, with FDIC participation. That formally notified Superior's Board of Directors of deficiencies and required that the board take several actions, including:

- developing procedures to analyze the valuation of the bank's residual interests, including obtaining periodic independent valuations;

[15] 12 C.F.R. Part 570.

- developing a plan to reduce the level of residual interests to 100 percent of the bank's Tier 1 or core capital within 1 year;
- addressing issues regarding the bank's automobile loan program; and
- revising the bank's policy for allowances for loan losses and maintaining adequate allowances.

On July 7, 2000, OTS also officially notified Superior that it had been designated a "problem institution." This designation placed restrictions on the institution, including on asset growth. Superior Bank submitted a compliance plan, as required, on August 4, 2000.[16] Due to the amount of time that Superior and OTS took in negotiating the actions required, this plan was never implemented, but it did serve to get Superior to cease its securitization activities.

Table 1: Enforcement Actions Taken by OTS Against Superior Bank or its Holding Companies

Date	Type of enforcement action	Key provisions of the action
July 5, 2000	Part 570 Safety and Soundness	Develop and implement a compliance plan to limit asset concentration in residual interests to 100 percent of core capital.
February 12, 2001	Prompt Corrective Action Notice	Develop a capital plan by March 14, 2001, intended to bring capital up to the adequately capitalized level.
February 14, 2001	Prompt Corrective Action Directive	Prohibit asset growth and require weekly sales of all loans originated during the previous week.
February 14, 2001	Consent Orders to Cease and Desist for Affirmative Relief	Implement modifications to the loan purchases between the holding companies and Superior.
February 14, 2001	Consent Orders to Cease and Desist for Affirmative Relief	Require holding companies to establish escrow accounts at Superior Bank and deposit sums equal to two times the aggregate amount of any loss reasonably projected on the sale of all loans originated.
May 24, 2001	Prompt Corrective Action Directive	Requires Superior to increase its capital—condition imposed in writing in connection with the approval of its capital plan.
May 24, 2001	Stipulation and Consent to Individual Minimum Capital Requirement	Modify capital requirements to allow Superior to hold less capital than established under Prompt Corrective Action.

Source: OTS.

While Superior and OTS were negotiating over the Part 570 plan, Superior adjusted the value of its residual interests with a $270 million write-down. This, in turn, led to the bank's capital level falling to the "significantly

[16]In response to OTS requests on September 1 and October 27, 2000, Superior's board provided additional information on September 29 and November 13, 2000.

undercapitalized" category, triggering a PCA directive that OTS issued on February 14, 2001.[17]

The PCA directive required the bank to submit a capital restoration plan by March 14, 2001.[18] Superior Bank, now with new management, submitted a plan on that date, that, after several amendments (detailed in the chronology in app. I), OTS accepted on May 24, 2001. That plan called for reducing the bank's exposure to its residual interests and recapitalizing the bank with a $270 million infusion from the owners. On July16, 2001, however, the Pritzker interests, one of the two ultimate owners of Superior Bank, advised OTS that they did not believe that the capital plan would work and therefore withdrew their support. When efforts to change their position failed, OTS appointed FDIC as conservator and receiver of Superior.

Although a PCA directive was issued when the bank became "significantly undercapitalized," losses to the deposit insurance fund were still substantial. The reasons for this are related to the design of PCA itself. First, under PCA, capital is a key factor in determining an institution's condition. Superior's capital did not fall to the "significantly undercapitalized" level until it corrected its flawed valuation of its residual interests. Incorrect financial reporting, such as was the case with Superior Bank, will limit the effectiveness of PCA because such reporting limits the regulators' ability to accurately measure capital.

Second, PCA's current test for "critically undercapitalized," is based on the tangible equity capital ratio, which does not use a risk-based capital measure. Thus it only includes on-balance sheet assets and does not fully encompass off-balance sheet risks, such as those presented in an institution's securitization activities. Therefore, an institution might become undercapitalized using the risk-based capital ratio but would not fall into the "critically undercapitalized" PCA category under the current capital measure.

[17]Section 38 of the Federal Deposit Insurance Act authorizes PCA directives when a bank's capital falls below defined levels. In an effort to resolve a bank's problems at the least cost to the insurance fund, Section 38 provides that supervisory actions be taken and certain mandatory restrictions be imposed on the bank. (12 U.S.C. §1831o)

[18]On February 14, 2001, OTS also issued two consent orders against Superior's holding companies.

Finally, as GAO has previously reported, capital is a lagging indicator, since an institution's capital does not typically begin to decline until it has experienced substantial deterioration in other components of its operations and finances. As noted by OTS in its comments on our 1996 report:

> "PCA is tied to capital levels and capital is a lagging indicator of financial problems. It is important that regulators continue to use other supervisory and enforcement tools, to stop unsafe and unsound practices before they result in losses, reduced capital levels, or failure."[19]

Further, PCA implicitly contemplates that a bank's deteriorating condition and capital would take place over time. In some cases, problems materialize rapidly, or as in Superior's case, long-developing problems are identified suddenly. In such cases, PCA's requirements for a bank plan to address the problems can potentially delay other more effective actions.

It is worth noting that while Section 38 uses capital as a key factor in determining an institution's condition, Section 39 gives federal regulators the authority to establish safety and soundness related management and operational standards that do not rely on capital, but could be used to bring corrective actions before problems reach the capital account.

Similar Problems had Occurred in Some Previous Bank Failures

The failure of Superior Bank illustrates the possible consequences when banking supervisors do not recognize that a bank has a particularly complex and risky portfolio. Several other recent failures provide a warning that the problems seen in the examination and supervision of Superior Bank can exist elsewhere. Three other banks, BestBank, Keystone Bank, and Pacific Thrift and Loan (PTL), failed and had characteristics that were similar in important aspects to Superior. These failures involved FDIC (PTL and BestBank) and the Office of the Comptroller of the Currency (Keystone).

[19]Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions, Nov. 1996, GAO/GGD-97-18, page 71.

BestBank was a Colorado bank that closed in 1998, costing the insurance fund approximately $172 million. Like Superior, it had a business strategy to target subprime borrowers, who had high delinquency rates. BestBank in turn reported substantial gains from these transactions in the form of fee income. The bank had to close because it falsified its accounting records regarding delinquency rates and subsequently was unable to absorb the estimated losses from these delinquencies.

Keystone, a West Virginia bank, failed in 1999, costing the insurance fund approximately $800 million. While fraud committed by the bank management was the most important cause of its failure, Keystone's business strategy was similar to Superior's and led to some similar problems. In 1993, Keystone began purchasing and securitizing Federal Housing Authority Title I Home Improvement Loans that were originated throughout the country. These subprime loans targeted highly leveraged borrowers with little or no collateral. The securitization of subprime loans became Keystone's main line of business and contributed greatly to its apparent profitability. The examiners, however, found that Keystone did not record its residual interests in these securitizations until September 1997, several months after FAS No. 125 took effect. Furthermore, examiners found the residual valuation model deficient, and Keystone had an unsafe concentration of mortgage products.

PTL was a California bank that failed in 1999, costing the insurance fund approximately $52 million. Like Superior Bank, PTL entered the securitization market by originating loans for sale to third-party securitizing entities. While PTL enjoyed high asset and capital growth rates, valuation was an issue. Also, similar to Superior Bank, the examiners over-relied on external auditors in the PTL case. According to the material loss review, Ernst & Young, PTL's accountant, used assumptions that were unsupported and optimistic.

Appendix I: Summary of Key Events Associated with the Failure of Superior Bank

An abbreviated chronology of key events is described in table 1 below. Some details have been left out to simplify what is a more complicated story. Readers should also keep in mind that ongoing investigations are likely to provide additional details at a later date.

Table 1: Summary of Key Events Associated with the Failure of Superior Bank

Date	Event
December 1988	Superior Bank was formed through the acquisition of Lyons Savings. The Pritzker and Dworman families purchase troubled Lyons Saving in a Federal Savings and Loan Insurance Corporation (FSLIC) assisted transaction.
1989 - 1997	The Office of Thrift Supervision (OTS) rated Superior Bank a composite "3" in 1989 and upgraded it to a "2" in 1991. OTS' rating stayed at that level until it was upgraded to a "1" in 1997. The Federal Deposit Insurance Corporation (FDIC) performed concurrent examinations of Superior and gradually upgraded Superior's composite rating from a "4" in 1990 to a "3" in 1991 and 1992 and to "2" in 1993. When Superior's condition stabilized in 1993, FDIC began relying primarily on off-site monitoring.
June 1992	Superior payed its first dividend, $1.5 million in cash, to its holding company, Coast-to-Coast Financial Holdings. The dividend represented 78 percent of net earnings for the fiscal year ending June 30, 1992. From 1992 through 2000, Superior paid out approximately $200.8 million in dividends ($169.7 million in cash and $31.1 million in financial receivables) to its holding companies.
December 1992	Superior Bank acquired Alliance Funding Company, a large-scale mortgage banking company. Alliance Funding Company's focus was on low credit quality home equity (subprime) lending, which became the core of Superior Bank's operations.
March 1993	Superior Bank executed its first securitization of subprime mortgage loans for the secondary market and began booking residual interests on its balance sheet.
July 1993	OTS examination identified concerns with Superior's mortgage banking operations, including increasing levels of excess mortgage servicing rights which had a higher level of risk than traditional investments and non-conforming loans involve a higher level of risk than traditional lending.
June 1994	OTS examination reported that Superior's mortgage banking operation, and the continued investment in the residual interests originated by Superior, exposed the institution to a somewhat greater risk than normal.
1995	Superior created an auto lending division with plans to securitize and sell the loans in a manner similar to the mortgage loans.
October 1995	OTS examination disclosed a potential concern with the level of residual interests in Superior's inventory. As of June 30, 1995, residual interests comprised 100 percent of core capital.
October 1995	OTS examination disclosed that a $2.6 million reserve established to protect the residual interests from the changing business cycle was improperly counted toward risk-based capital. OTS Regulatory Plan noted that the removal of this reserve from the capital calculation could result in Superior Bank's falling below the threshold for well-capitalized institutions.
December 1995	OTS Regulatory Plan noted that residual interests totaled $108 million representing roughly 142 percent of core capital as of December 31, 1995. The regulatory plan stated that this concentration posed a risk to capital since accelerated repayment of the underlying loans—due to a downward movement of interest rates or other reasons—would cause a downward valuation of the residual interests.
October 1996	OTS examination concluded that the residual interests were adequately valued.
October 1997	OTS examination of Superior upgraded the composite rating to a "1". The Report of Examination noted that this review disclosed no concerns with management's calculations on the gains from the sale of loans and the resulting imputed financial receivables.
September 1998	FDIC performs an off-site review of Superior Bank using the Thrift Financial Reports and the audited financial statements as of June 30, 1998. FDIC concluded that (1) while Superior had not been identified as a "subprime" lender in the past, interest rates exhibited by its current held-for-sale loan portfolio were characteristic of such portfolios; (2) Superior exhibited a high-risk asset structure due to its significant investments in the residual values of the securitization of loans and held for sale loans that exhibited interest rates that were substantially higher than peer; and (3) Superior had substantial recourse exposure in loans "sold" through its securitization program.

Date	Event
December 1998	FDIC wrote a request to the OTS regional director requesting FDIC participation in the upcoming January 1999 OTS examination. The letter stated the key findings of the off-site review and requested FDIC's participation in the upcoming exam "to better understand the potential risk Superior's operations may represent to the FDIC insurance fund."
January 1999	OTS regional director and assistant regional director verbally denied FDIC's request to participate in the exam. Their rationale was that Superior was rated a composite "1" at its last examination and it was not the regular practice of FDIC to participate in OTS exams of thrifts with such ratings. In addition, they raised concerns over possible negative perceptions an on-site FDIC presence might cause due to litigation between Superior and FDIC.
March 1999	OTS completed safety and soundness examination and downgraded Superior to a composite rating of "2." The Report of Examination identified two items requiring action by Superior's Board of Directors. The first item involved problems with the asset classification and the allowance for loans and lease losses. The second item involved the need to establish adequate procedures to analyze the ongoing value of the financial receivables and servicing rights related to auto loans and that the book value of these assets be adjusted in accordance with FAS 125. The exam also concluded that the valuations of the residual interests, which represented 167 percent of tangible capital as of December 31, 1998, were reasonable.
May 1999	FDIC lowered Superior's composite rating to a "3" on the basis of off-site monitoring and the OTS 1999 examination. In June 1999, FDIC sent a memorandum to the OTS regional director stating that a composite rating of "3" was more appropriate and reflective of the overall risk inherent in Superior. The memorandum stated that "off-site analysis of the following conditions and ongoing trends lead us to believe that Superior's current risk profile is unacceptably high relative to the protection offered by its capital position. Some of these trends and conditions include: (a) high growth/concentrations in residual value mortgage securities and loan servicing assets; (b) substantial growth/concentrations in high-coupon (about 250 basis points higher than peer) mortgage loans sold with recourse; (c) substantial concentrations in "high-coupon" on-balance sheet mortgage loans; (d) explosive growth in high coupon (900 basis points more than peer) auto loans that has resulted in a concentration exceeding T1 capital; (e) an increase in repossessed assets (mostly autos) to about 20% of T1 capital, with the majority classified doubtful or loss by the OTS; and unusual regulatory reporting that reflects residual securities reserves in the general ALLL."
September 1999	FDIC sent a formal request to OTS requesting participation in the 2000 examination. FDIC received written concurrence from OTS on September 24, 1999.
October 1999	OTS conducted a field visit to review the 1999 examination findings of deficiencies in management reporting of classified assets and the apparent continued reporting deficiencies in two subsequent regulatory reports.
May 2000	OTS and FDIC completed a joint exam of Superior (as of 1/24/00) and assigned a composite rating of "4." The exam described the need for a number of corrective actions including the need for Superior to obtain an "independent valuation of the financial receivables related to the 1998-1 and 1999-1 securitizations from a third party source in order to validate the results produced by the internal model."
July 2000	OTS issued a Notice of Deficiency and Requirements for Submission of a Part 570 Safety and Soundness Compliance Plan letter to Superior Bank. Superior was required to submit an acceptable Safety and Soundness Compliance Plan (Corrective Plan) by August 4, 2000. Among other things, the corrective plan was to provide for the development and implementation of procedures for analyzing the fair market value of the residual interests and auto financial receivables and adjusting the book value of these assets in accordance with FAS No.115. Superior's corrective plan was also to address credit underwriting, concentration of credit risk, and Allowance for Loan and Lease Losses issues. As part of the 570 enforcement action, the bank was required to reduce its level of financial receivables and related assets to no greater than 100 percent of Tier 1 capital within a year.
October 2000	OTS and FDIC conducted a joint field visit to determine management's compliance with promised corrective actions from the earlier on-site examination. The field visit report concluded that Superior's financial statements were not fairly stated at the most recent audit date of June 30, 2000, due to incorrect accounting for the financial receivables and overcollateralization assets, which resulted in inflated book entries on the balance sheet for the respective assets, earnings and capital. The examiners also concluded that the most recent audit report, prepared by Ernst & Young as of June 30, 2000, should be rejected and that the audit report should be restated

Date	Event
	to reflect the adjustments resulting from the field visit.
February 2001	Ernst & Young agrees with the regulators that the accounting for the financial receivables and overcollateralization assets were incorrect.
February 2001	OTS determined that Superior Bank was significantly undercapitalized on or before December 31, 2000, as a result of adjustments from the January 2000 exam and October 2000 field visit. OTS issued a PCA Directive that required the bank to submit a capital restoration plan by March 14, 2001. OTS terminated its review of the institution's Part 570 corrective plan as a result of the issuance of the PCA directive. OTS also issued two Consent Orders to Cease and Desist for Affirmative Relief against Superior's holding companies (Coast-to-Coast Financial Corporation and Superior Holding, Inc.). One was issued to implement modifications to the loan purchases between the holding companies and Superior "in order to eliminate losses experienced by the Savings Bank within the lending program." The other order required the holding companies to establish an escrow account at Superior Bank and deposit sums "equal to two times the aggregate amount of any loss the Savings Bank reasonably projects it will incur on the sale of all loans originated by the Savings Bank during the current calendar week, or $5 million, whichever is greater."
March 2001	Superior Bank and Ernst & Young completed a revaluation for all the financial receivables and overcollateralization assets using the correct accounting methodology and calculating from the inception date of each securitization pool. The recalculation resulted in a required write-down of the financial receivables and overcollateralization assets totaling $270 million. On March 2, 2001, Superior amended its December 31, 2000, TFR to reflect the correct fair market value of the F/R and O/C assets. OTS performed an off-site examination of Superior Bank and downgrades its composite rating to a "5."
May 2001	OTS conditionally approved Superior Bank's amended capital restoration plan (plan initiated submitted by Superior on March 14, 2001, and amended on April 30, May 15, and May 18, including revisions received by OTS on May 19 and May 21) and issued a Prompt Corrective Action Directive requiring the bank to increase its capital levels by complying with the terms of the capital restoration plan.
July 2001	A $150 million write-down of the residual interests was necessitated by overly optimistic assumptions used in Superior's valuation model.
July 2001	Pritzker interests sent a letter to OTS indicating that the plan will not work and OTS closed Superior Bank, FSB, and placed the bank under conservatorship of FDIC.
December 2001	FDIC and OTS reached a resolution with the holding companies of Superior Bank on "all matters arising out of the operation and failure of Superior Bank. Under the terms of the agreement, the Superior holding companies and their owners (the Pritzker and Dworman interests) admit no liability and agreed to pay the FDIC $460 million and other consideration."