S. HRG. 107–698

THE FAILURE OF SUPERIOR BANK, FSB HINSDALE, ILLINOIS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

THE FAILURE AND IMPLICATIONS OF SUPERIOR BANK, FSB, HINSDALE ILLINOIS, FOCUSING ON THE NEED FOR CONTINUED REGULATORY VIGILANCE, MORE STRINGENT ACCOUNTING, AND CAPITAL STANDARDS FOR RETAINED ASSETS

SEPTEMBER 11 AND OCTOBER 16, 2001

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THE FAILURE OF SUPERIOR BANK, FSB HINSDALE, ILLINOIS

TUESDAY, SEPTEMBER 11, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. The hearing will come to order.

We obviously are confronted with an extremely serious situation. My own view, very frankly, is that we should not to let these people simply close down not only the Government of the United States, but close down the United States, despite some very harrowing things that are happening. So it is my intention, unless I receive word to the contrary from higher authorities, to proceed with this hearing this morning. We have all the witnesses here, unless their panic quotient is very high, I intend to go ahead.

This morning, the Committee will hear testimony on the failure of Superior Bank of Illinois. Press reports estimate that the loss to the Savings Association Insurance Fund will approximate $500 million. It is the largest U.S.-insured depository institution by asset size to fail since 1992.

On July 27, just a couple of months ago, the Office of Thrift Supervision closed Superior Bank after finding that the bank was critically undercapitalized. That is, tangible equity capital was less than 2 percent of its total assets. The OTS stated that Superior's problems arose from, ". . . high-risk business strategy which was focused on the generation of significant volumes of subprime mortgage and automobile loans for securitization and sale in the secondary market, while keeping residual assets."

The OTS found "Superior became critically undercapitalized largely due to incorrect accounting treatment and aggressive assumptions for valuing residual assets."

Shortly after this failure, I asked the General Accounting Office and the Inspector Generals of the Federal Deposit Insurance Corporation and the Department of the Treasury to thoroughly review why the failure of Superior Bank resulted in such a significant loss to the deposit insurance fund, and to make recommendations for preventing any such loss in the future. I look forward to their reports and as soon as they are completed, which I anticipate would

be relevant to the next session of the Congress, we will hold further hearings to review their findings.

I am very deeply concerned about the impacts of this failure. For the SAIF, this failure will cause a material financial loss estimated currently at $500 million, but with the expectation that it may, in fact, be larger. Uninsured depositors will suffer losses of their savings and the failure raises concerns about the supervision of our Federally insured depository institutions.

Obviously, the failure of a $2 billion thrift raises many concerns relevant to the oversight responsibilities of this Committee involving how the failure happened, its impact, and how to prevent similar failures in the future. During today's hearings, I hope we can focus on several important questions. We appreciate that there are investigations going on that may involve important questions of liability with respect to superior and to its owners, and we do not want to intrude into that investigative process, so we are focusing in a different direction.

Are there characteristics of Superior Bank that it shared with other institutions that have failed in the past few years, such as First National Bank at Keystone, Pacific Trust & Loan, BestBank, or OceanMark Bank? If so, were these, or should these have been red flags to the regulators?

I am particularly concerned that there seems to be a pattern of failed institutions that have held high concentrations of risky residual assets with which the regulators have not yet fully dealt.

Are there other thrifts or banks with heavy concentrations of assets that the regulators would consider as extremely risky? Did the primary regulator, OTS, effectively supervise Superior? Did the OTS and the insurer, the FDIC, cooperate effectively? Does the FDIC need more authority to effectively exercise its back-up role? Why did Prompt Corrective Action after it was applied fail to prevent this failure? Are regulatory or legislative changes needed to reduce the likelihood of future failures? In particular, after the failure of Keystone 2 years ago, at a loss of just under $800 million, why did the four Federal financial regulators not adopt stronger rules governing the holdings of risky residual assets?

These and other issues we hope to address today. We have two panels of witnesses. Our first panel includes the Director of the OTS, Ellen Seidman. The OTS, of course, is the primary regulator with respect to Superior Bank. And Former Acting Chairman of the FDIC and current FDIC Director, John Reich. Actually, we welcome John back to the Senate where he worked for many years as Chief of Staff to Senator Connie Mack, a distinguished former Member of this Committee.

Our second panel includes three distinguished experts in the banking industry: Bert Ely, President of Ely & Company of Alexandria, Virginia; Dr. George Kaufman, John F. Smith, Jr. Professor of Finance and Economics at Loyola University Chicago; and Karen Shaw Petrou, Managing Director of Federal Financial Analytics here in Washington.

I will turn to my colleague, Senator Johnson, for any statement he might have.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Mr. Chairman, for conducting this timely and important hearing. I think all of us here in this room today are having some difficulty focusing on the important issues at hand relative to the Superior Bank failure, given what has happened to our Nation this morning with now the collapse of the World Trade Center building and the attacks in Washington. My thoughts and prayers certainly go to the very many families that must be suffering great anguish as we speak here today. It is important for the principles of our democracy and the strength of our Nation to remain intact, and that is what we are about in this hearing.

Mr. Chairman, I thank you for holding this hearing on the failure of the Superior Bank of Hinsdale, Illinois. I doubt that I was the only one who was surprised to learn of the thrift's failure on July 27 of this year.

Since that time, there has been a lot of finger-pointing among the parties involved. I happen to believe that today is not about assigning blame or passing the buck. We clearly have a problem and today, our task is to get to the bottom of it so that it simply does not happen and the likelihood of it happening again is minimized. There are sure to be lessons learned from the failure of Superior and I hope that we can get beyond the finger-pointing today.

Of course, we will take a hard look at many different issues, including Prompt Corrective Actions, methods evaluation, the role of accounting auditors, and interagency cooperation, to name a few.

While today's hearing is likely to focus on these more technical issues, we should not lose sight of the fact that it is exactly situations like the Superior failure that emphasize the critical role that Federal deposit insurance plays in the lives of ordinary Americans.

FDIC is one of the cornerstones of our financial system, and it is worth pausing to note that the failure of Superior Bank appears to have caused little, if any, public panic about the health of our banking system. That is the goal of the Federal deposit insurance. And it is no small feat. According to FDIC policy for a conservatorship situation, they typically close a failed institution on a Friday after the close of business, with the goal of reopening on a Monday in a way where the customers would be hard-pressed to identify any differences in the bank's operations.

Indeed, our deposit insurance system is premised on the assumption that banks and thrifts will, on occasion, fail, despite the best efforts of regulators. On that point, we should remember that the regulatory agencies deserve significant credit for their hard work in keeping our banking system healthy. Their task is especially challenging where there is fraud by the institution, or serious error by a national auditor.

However, I find this failure to be especially notable, as were the failures of First National Bank of Keystone and BestBank, because of the magnitude of the failure proportional to the size of the institution. The loss estimates for Superior range from $500 million to $1 billion, with a loss rate of anywhere from 20 to 45 percent. Some experts estimate that the failure could cost around a 7 basis point drop in the SAIF ratio, which, as I have said in the past, should

help to focus Congress and industry alike on the need to consider reforms to our Federal deposit insurance system.

Mr. Chairman, I am particularly troubled by the losses to Superior's uninsured depositors. While the numbers have not been confirmed, FDIC estimates that the uninsured depositors held upward of $50 million in Superior on July 27. According to one report, 816 depositors held $66.4 million in uninsured deposits on the day Superior was shut down.

Even worse, to my mind, is the fact that Superior's uninsured deposits increased by $9.6 million in the second quarter of this year, when the regulators knew that the bank was in trouble.

Who were these uninsured depositors? Clearly, some were sophisticated investors who knew enough to pull their money out of Superior when call report data indicated a precarious situation for the bank, even though sophisticated investors were challenged in evaluating the health of the thrift given reports of Superior's egregious misrepresenting on its thrift financial reports. As one of the witnesses included in his written statement, call report data posted on the FDIC website was inaccurate as late as June of this year.

And as for the rest of the uninsured depositors, press reports are informative. For example, a former parcel carrier who was injured on the job had deposited a hard-fought settlement of $145,000 of his money in Superior on July 26, the day before the Hinsdale thrift collapsed. Another woman deposited $120,000 in proceeds from her recently deceased mother's home just days before Superior was closed by the regulators. In addition, it has been reported that many individuals held uninsured retirement savings at Superior.

I hope either today or at some point in the near future, we will receive more details on how many of the uninsured deposits at Superior Bank were retirement funds and how they came to be parked at Superior.

As I have indicated previously, Congress has a responsibility to think about the appropriate level of Federal deposit insurance for retirement funds. We provide tax incentives for people to save for their retirement and in fact, we recently increased those savings incentives. People who set aside relatively modest amounts every year for retirement can easily amass more than $100,000. It seems to me that the next step for Congress is to make sure that our working families have the option of a safe investment for those funds. To keep us informed, I am calling on the FDIC to release additional information, even in redacted form, to this Committee.

I thank the witnesses for their extensive and thoughtful written testimony and I once again thank you, Mr. Chairman, for calling this hearing in a timely manner, even during these difficult times.

Chairman SARBANES. Thank you very much, Senator Johnson.

I am happy now to turn to our witnesses. Ms. Seidman, we will hear from you first, and then from Mr. Reich.

Ordinarily, we ask our witnesses to try to limit their oral presentation to 10 minutes. I understand when the OTS people were told that, they reacted quite strongly, saying that it was not possible for Ms. Seidman to condense what she had down to 10 minutes.

Ms. SEIDMAN. Actually, Senator, I have succeeded.

Chairman SARBANES. Well, I was going to tell you that we were going to give you the extra time. You are the regulator that is on

the spot and we want to hear from you. We want to make sure that you do not walk away from the table saying the Committee did not give me a chance to present. So if you need to take some time over the 10 minutes, not unreasonably, I invite you to do so.

We will now be happy to hear from you.

STATEMENT OF ELLEN SEIDMAN
DIRECTOR, OFFICE OF THRIFT SUPERVISION

Ms. SEIDMAN. Thank you very much, Senator.

Mr. Chairman, Senator Johnson, I welcome this opportunity to speak to you about the failure of Superior Bank and some of the policy issues raised by that failure.

Before I start, I understand, and I believe from Senator Johnson's own statement, that some Committee Members are concerned that I did not mention Superior, whether by name or otherwise, in my testimony on the state of the thrift industry on June 20. So, today, I want to be very clear about the troubled institution situation in the thrift industry.

As of yesterday, there were 17 thrifts out of a total of 1,045 rated CAMELS "4" or "5". Were you to ask me whether one of these institutions might fail within the next 6 months, I would have to say yes. Were you to ask me whether one of these institutions will fail, I would have to answer that I do not know and that we at OTS, as the other bank regulators with respect to the troubled institutions they supervise, are working hard to get those institutions returned to health, merged or acquired, or voluntarily liquidated. And many of the 17 are well on their way.

During my tenure at OTS and for years before, there have been far more successes than failures. In fact, this is the third failure on my watch. A good result for the financial system, but, unfortunately, for us, there are no headlines about successes and no hearings about them.

Superior was, when it failed, a $1.8 billion privately owned institution, held 50 percent by the Pritzker and 50 percent by the Dworman families. Under the FSLIC assistance program, the two families had purchased Superior's $1.5 billion troubled predecessor, Lyons Savings Bank, in 1988, and infused $42 million into it. While Superior's new owners had difficulty stabilizing the newly acquired institution, by 1993, both OTS and the FDIC rated it CAMELS "2". OTS raised the institution's rating to CAMELS "1" in October 1997, and the FDIC did not raise any concern.

Starting in 1993, Superior built its mortgage banking business. And, as with most mortgage bankers and an increasing number of subprime lenders, Superior was not holding the loans in its portfolio. Rather it was securitizing them, the process, described more fully in my written statement, 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. Superior, like many issuers, held onto the residual, the security with the greatest amount of risk or otherwise provided significant credit enhancement.

In theory and in practice, this process has both expanded and liquified the market for many credit products. However, as described more fully in my written testimony, both the gap accounting and regulatory capital treatment of these instruments means

that securitization can also be a way to increase the scope of operations, leverage the balance sheet with capital that consists of little other than assumptions about future cashflows, create real uncertainty about the quality of both regulatory reporting and audited financial statements. When the gap in regulatory accounting is incorrect, when the cashflows do not materialize as anticipated, and when the institution goes faster than it seems able to control, problems arise, as they did at the failed institutions that you mentioned in your opening statement, Chairman Sarbanes.

During 1999, both the OTS and the FDIC started having serious concerns about Superior. 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. We rated the institution a "2" in March 1999. The FDIC was more focused on the increasing concentration of residuals and rated it a "3" in May. By July, however, both agencies were increasingly focused on the concentration and evaluation of residuals. The institution's management resisted making changes and, to some extent, you can understand why. In May 1999, Fitch, which rated Superior's long-term debt an investment-grade triple B, stated——I am sorry, sir?

Chairman SARBANES. The Capitol police apparently are moving people out of the building. And as I indicated at the outset, if that sort of request or order came through, we obviously would honor it. So, we will have to suspend the hearing, to be resumed at some opportune time. We thank the witnesses for coming. We apologize. But I am sure they understand our situation.

This hearing is recessed until further call of the Chair, which will not be today, I would also add. And we will hold Ms. Seidman to her 10 minutes the next time we come together.

Thank you all very much.

[Whereupon, at 10:25 a.m., the hearing was recessed, to reconvene at the call of the Chair.]

THE FAILURE OF SUPERIOR BANK, FSB HINSDALE, ILLINOIS

TUESDAY, OCTOBER 16, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:30 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. The hearing will come to order.

I expect that our other colleagues will be along shortly. We have been receiving a briefing on yesterday's events and our authorities seem to have it under control.

We are, of course, resuming the hearing on the failure of the Superior Bank that began on September 11, and we are pleased to have our witnesses back before us. I will be very brief in my opening statement because I want to return to our witnesses and give them a chance to get their statements in this time, at least.

Press reports have estimated the losses to the SAIF, the Savings Association Insurance Fund, will approximate $500 million in the Superior Bank. Others are estimating even higher. I have seen some estimates higher. It is the largest U.S.-insured depository institution by asset size to fail since 1992.

On July 27, OTS closed Superior Bank after finding that it was critically undercapitalized; that is, tangible equity capital was less than 2 percent of its total assets. OTS stated that Superior's problems arose from a high-risk business strategy which was focused on the generation of significant volumes of subprime mortgage and automobile loans for securitization and sale in the secondary market, while keeping residual assets. OTS found, "Superior became critically undercapitalized largely due to incorrect accounting treating and aggressive assumptions for valuing residual assets."

Shortly after this failure, the Committee asked the General Accounting Office and the Inspector Generals of the Federal Deposit Insurance Corporation and the Department of the Treasury to look into the matter, and we look forward to receiving their reports.

For the SAIF, this failure will cause a large financial loss. For people whose savings accounts had more than $100,000 and, thus, held uninsured deposits, it is estimated there is about $60 million of that, so there will be a significant cost there. And for the public, generally, the failure of a major bank is unsettling and raises questions about the supervision of U.S. depository institutions.

There are a number of questions that I hope we will touch on today in the course of this hearing.

First, are there characteristics of Superior Bank that are shared with other institutions that have failed in the past few years, such as First National Bank of Keystone, Pacific Trust & Loan, BestBank, or OceanMark Bank? If so, were these, or should these have been red flags to the regulators?

I am particularly concerned that if there is a pattern of failed institutions that held high concentrations of subprime residual assets, which the regulators have not yet effectively dealt with. Are there other thrifts or banks similar to Superior in difficult situation? Did the primary regulator, OTS, effectively supervise Superior? Did the OTS and the insurer, the FDIC, cooperate effectively? Does the FDIC need more authority to effectively exercise its backup supervision? Why did Prompt Corrective Action after it was applied fail to prevent the failure of Superior? Are regulatory or legislative changes needed to reduce the likelihood of future failures? We are particularly interested in this issue. And especially, why, after the failure of Keystone in September 1999, at a loss of $780 million, the Federal financial regulators have not yet adopted a strong rule governing the holding of subprime residual assets?

We look forward to examining these issues today. We have two panels. The first panel, which is at the table, includes the Director of the OTS, which had primary regulatory responsibility for Superior Bank, Ellen Seidman, and the Former Acting Chairman of the FDIC and current FDIC Director, John Reich.

I welcome both witnesses before the Committee and, Mr. Reich, I just want to comment that we are pleased to have you back with the Senate because we know you worked here for many years as Chief of Staff to Senator Connie Mack of Florida, who of course was a very distinguished Member of this Committee.

We would be happy to hear from the witnesses. Ms. Seidman, we will obviously start with you.

STATEMENT OF ELLEN SEIDMAN
DIRECTOR, OFFICE OF THRIFT SUPERVISION

Ms. SEIDMAN. Thank you, Mr. Chairman.

Since the adjournment of this hearing on September 11, in the wake of terrorist attacks on the World Trade Center and the Pentagon, OTS, like the other Federal bank regulators, has been heavily focused on maintaining both the strength of and confidence in the banking system and ensuring that the banking system is working with law enforcement to do its part to trace, freeze, and stop flows of assets and funds to terrorists and those related to them. I have not had an opportunity to report to you on our actions, so I would just like to go over them briefly.

First, of course, we made certain that all of our employees were accounted for and safe and, fortunately, they were. Starting on September 12 and continuing through the following week, we had regular conference calls and video calls with our regional directors, other bank supervisors, and members of the financial markets working group. These were to gather and share information and to ensure that our regional directors, particularly those in New Jersey and in Atlanta, which serves the D.C. area, were aware of and able

to deal with any operational or customer service issues. Fortunately, there were few issues after the first day or so, and some institutions concerned about the availability of cash who put temporary limits on withdrawals, were lifted.

On September 12, and again on the September 14, we issued press releases and letters to CEO's urging thrifts to accommodate the needs of borrowers impacted by the events of September 11, including those affected only by delays in mail service. We noted that assistance to the community would be taken into account in an institution's CRA evaluation.

On September 13, we joined other bank regulators in issuing guidance concerning temporary impacts on capital, and during the following weeks, we issued a release and CEO letter informing thrifts of their obligations under the Soldiers and Sailors Civil Relief Act and a series of releases and CEO letters concerning responsibilities under the Foreign Assets Control Act, the Executive Order issued on September 24, and requests by the FBI and other law enforcement agencies to assist in tracking terrorist funds. We have continued to keep up with our institutions to make certain that any concerns or difficulties are quickly resolved.

I can report that the Nation's thrifts have responded well to the events of September 11 and are effectively serving their customers, their communities, and the greater needs of the Nation.

Now before I get really into Superior, I understand that the Chairman perhaps and some other Committee Members are concerned that I did not mention Superior, whether by name or otherwise, in my testimony on the state of the thrift industry on June 20. So, I want to be really clear today about the current troubled institution situation.

As of yesterday, there were 16 thrifts out of a total of 1,037 OTS-supervised institutions that were rated CAMELS "4" or "5". That is 16 out of 1,037. Were you to task me whether one of these institutions might fail within the next 6 months, I would have to answer yes. That is what a CAMELS rating of "4" or "5" suggests as a possibility. Were you to ask me whether one of these institutions will fail, I would have to answer that I do not know and that the deteriorating economic environment on which a number of you have been or are scheduled to be briefed by the FDIC makes failures more likely.

However, I will also assure you that we at OTS, as the other bank regulators with respect to the troubled institutions they supervise, are working hard to get those institutions returned to health, merged or acquired, or voluntarily liquidated, and many are well on their way.

During my tenure at OTS and for years before, there have been far more successes than failures. In fact, during my 4 years, 53 different institutions have at some point been rated CAMELS "4" or "5". There were only 3 failures. This is a good result for the financial system, but there are, of course, no headlines about the successes and no hearings on them.

My written statement goes into substantial detail about the regulatory history of Superior through its failure on July 27. And in the interest of time, I will not repeat it here. But I believe it is a history of, since 1999, constant and consistent regulatory escalation,

with some success, in the face of complexity, substantial mistakes by professionals, and management and board recalcitrance. Were there things that, in retrospect, we might have done better? Yes. In particular, I believe we should have pushed management, the thrift board, and the holding company board harder to honor the commitments they, in fact, made in a timely manner, from May 1999, right through to July 23 of this year.

But responsibility for the success or failure of any depository institution rests with its management directors and owners. We have an investigation underway to determine the causes of the failure and what enforcement action is appropriate. And at this stage, we have issued 27 subpoenas to corporations and individuals.

As you know, and as you have mentioned, others are also pursuing the causes of the failure. Since late July, OTS staff has spent approximately 100 staff-hours in direct discussions with the Treasury IG, the FDIC IG, and the GAO, and many more hours in preparation for those sessions. We have copied and made available for review in excess of 130,000 pages of documents. I would now like to turn to seven broad areas raised by Superior, other recent failures and other high-risk or troubled institutions, and I hope in this context I can answer some of the issues that the Chairman has raised in his opening statement. All of this is covered more extensively in my written testimony. In some cases, however, this oral presentation provides updated information on action we have taken since this hearing recessed.

First, subprime lending. The consistently higher proportion of subprime lenders found in the troubled institution category both at OTS and overall confirms that there are special risks in this business. They go beyond credit risk to operational risk, prepayment risk, reputation and legal risk, and when done in the volumes that are possible only through securitization or constant loan sales, liquidity, and funding risk.

OTS first warned the thrift industry about the heightened risks of subprime lending in June 1998. This was followed by interagency subprime guidance in March 1999. By this January, interagency guidance that included guidance on the appropriate level of capital to hold against subprime loans, and on August 17, by a series of questions and answers concerning the guidance. In this area, the major additional regulatory step that needs to be taken relates to better gathering of information.

OTS had notified the thrift industry that we would begin collecting data on subprime lending with the September 2001 TFR. But we have delayed collection to coordinate with the bank regulators. We need to move quickly, in a manner that enables all the Federal bank regulators to collect qualitative data on who is in this business, even if we cannot get highly accurate quantitative information. With the support of Chairman Powell, Comptroller Hawke, and Governor Meyer, in September, this process recommenced through the FFIEC supervisory and reporting task forces. Of course, regulations, guidance, and reporting must be accompanied by enhanced supervisory action.

Second, securitization. Securitization provides an opportunity to liquify a loan portfolio and can be used to transfer some portion of interest and credit risk to other parties. Current risk-based capital

rules are structured to, in general, allow issuers of securities to carry less capital against securitized assets than against those same assets when they are on the books. In effect, securitization increases an institution's financial and operating leverage, creating a situation where the institution's profitability is dependent on a large and generally growing volume of business. The risks inherent in such a structure are exacerbated when the institution concentrates its securitization of subprime assets, for which the secondary market is particularly subject to disruption.

In December 1999, the Federal bank regulators issued guidance on asset securitization. The guidance addressed many of the concerns noted above and set forth fundamental risk management practices that the agencies expected of institutions that engage in securitization.

With respect to the relationship between securitization and risk-based capital, since 1993, the Federal bank regulators have recognized the potential for regulatory capital arbitrage created by the current rules and have been trying to issue a regulation on recourse and direct credit substitutes to respond to this problem. As is evident by the fact that the regulation is still not final 8 years later, the problem is not simple. Spurred in part, however, by the failure of Superior, the principals have instructed their staffs to move quickly to closure and we expect that final interagency action on this rule will happen this month.

As discussed more fully in my written statement, the financial leverage inherent in securitization is multiplied many times over when the issuer, in a quest to maintain a market for its securities and get the highest price, retains an ever-greater portion of the pool's unexpected risk. This is the retention of a residual interest, which may take a number of forms. Under GAAP, the present value of the entire future stream of income represented by the residual must be booked at the time the security is sold, so-called gain-on-sale accounting. Yet this stream is dependent on a number of highly subjective assumptions concerning the discount rate, default rate, and prepayment speed. And not only are these assumptions subjective, they change, sometimes dramatically, over time. These factors make the value of the residual extremely volatile and subprime residuals, with their lack of a secondary market, are even harder to value. There is currently no limit on the extent to which residuals can be counted as either leverage or risk-based capital for regulatory purposes.

In September 2000, in part as a result of the Keystone events, the regulators proposed to limit residuals to 25 percent of leveraged capital and to require that dollar-for-dollar risk-based capital be held for residuals. We are working quickly toward a final rule that will be part of the recourse and direct credit substitutes rule that I mentioned earlier that should be out by the end of this month. In addition, since March of this year, we have been collecting information on residuals on the thrift financial report, a process the other regulators started this June, and we are working to enhance that information.

The quarterly TFR data will be supplemented by more detailed database and risk assessment report compiled from information obtained through on-site exams and off-site analysis, and by revised

preexamination schedules on securitization, residuals and valuation assumptions. The combination of additional information, adoption of the proposed regulation, and increased regulatory vigilance should go a long way to reducing the risk represented by institutions whose capital was wholly or even mostly represented by residuals. Now while the residual rule, when adopted, should help resolve that problem, it highlights a much bigger issue. What appears to make sense for accountants may not coincide with the needs of regulators, particularly when it involves creation of speculative amounts of capital. In many ways, this is also what is at the heart of the debate concerning loan loss allowances.

Current law permits regulators to deviate from GAAP as long as our regulations are, "no less strict." We have been reluctant to do so, in large part, because the creation of two sets of books is not only confusing, but also burdensome, particularly for publicly held companies. We may, however, need to bite this bullet. But it would be better in the long run if the accounting profession were required, by statute if necessary, to consult with bank regulators and to consider in writing the impact of major accounting changes on depository institutions before such changes are promulgated. Three other important accounting issues are timely resolution of disputes, accounting competence, and accounting independence.

Protracted accounting disputes played a role in the failure of not only Superior, but also Keystone and PTL. This is currently a relatively low-risk proposition for institution management and its accountants. The longer the dispute goes on, the longer the institution can avoid booking the inevitably higher reserves or lower asset values the regulator is demanding. In most cases, these disagreements are resolved amicably and quickly. However, when the consequence of the regulators' position are large, as where it would cause the institution to drop a capital category, and that was very much what was at issue here, delay is often the winning strategy.

To get at this problem, we recommend that the Congress enact legislation providing that when a Federal bank regulator issues an accounting dispute letter concerning a dispute that could cause an institution to drop a PCA capital category, a 60 day clock for resolution would start, at the close of which, if there is no resolution, the regulator's position will be adopted for regulatory reporting purposes and therefore for PCA.

Accounting competence is also becoming a more serious issue as financial institutions enter into ever more complex transactions from an accounting perspective. It is essential that at least two people on any engagement team, including the engagement and review partners, understand the complexities of the major or primary line of business of the institution. This may not have been the case with the Superior accountants and is part of the subject of our investigation. We recommend that the AICPA and major accounting firms strengthen the requirements for training and experience. Finally, there is the issue of accounting independence.

First, many accountants assist clients with valuation of complex financial instruments such as residuals and regard this as part of their audit work. This means that the same accounting team that develops the valuation then audits it. We recommend that the

AICPA and the SEC limit the provision of valuation services in connection with an audit.

Second, we think it is time for Congress to encourage the AICPA and the SEC to give full consideration to an external auditor rotation requirement, at least for institutions of significant size. While there are definite economies to be gained from having the same auditor year after year, both regulators and investors would benefit from a periodic fresh look at large and complex institutions.

Now, I understand that there is concern over whether the regulators are using Prompt Corrective Action effectively. But I believe that the track record over the last several years, particularly when combined with safety and soundness actions under Section 39 of the FDIA has been good.

Since 1991, we have issued PCA directives to 47 institutions and directives under Section 39 to 30 different institutions. There are also some overlaps, yet only 8 of these institutions, including Superior, have failed.

Nevertheless, our recent experiences lead us to believe there is one improvement that could make PCA a good deal more effective. The section of PCA dealing with critically undercapitalized institutions, those that will be shut down in 90 days if not recapitalized, is the only portion of the statute that does not include a risk-based capital component. Rather, it is based solely on Tier 1 equity capital, which is essentially a GAAP definition.

In a world in which many of the riskiest institutions are booking capital for GAAP purposes that has little economic reality in a liquidation scenario, this is ineffective. We, therefore, recommend that a risk-based capital trigger be added to the definition of critically undercapitalized.

As Chairman Powell has noted, the FDIC as an insurer has an important role to play in assessing the health of insured institutions and also in attempting to limit claims on the insurance funds. However, the FDIC is not the primary Federal regulator of institutions holding the bulk of industry assets and we all need to work together better.

First, we need better information-sharing, including not only the sharing by the primary regulators of information we develop about institutions that we supervise, but also sharing by the FDIC of its analysis of institutions regulated by others. The forward-looking risk assessment essential to an analysis for insurance purposes can also be extremely helpful both in improving current supervision and what is sometimes more difficult—convincing banks' management and board of the need for a strategic change. I have discussed this issue with Chairman Powell and he has stated that he supports greater and more effective two-way information sharing.

Second, there needs to be better communication of potential problems relating to institution-specific issues at the Washington level. Regional coordination and communication with respect to individual institutions appears to be quite good and the staffs in Washington work well together on policy issues. But where there is a disagreement about an institution-specific issue at the regional level, we need a better process for bringing the issue to the attention of both staff of all agencies in Washington and, if necessary, the FDIC board.

Finally, I agree with Director Reich that we need to review and revise the 1995 procedural agreement concerning back-up supervision. This process has started, including a joint working group of very senior supervisory officials from all four Federal banking agencies. I hope it can conclude relatively quickly, and I have certainly encouraged my staff to do that. The final topic I want to cover is the issue of broader interagency coordination.

To the extent that regulations could have prevented the Superior failure, our inability to move more quickly on interagency recourse and residual rules has to be tagged as part of the problem. This is largely an area where the regulators have to have the will to improve, and that it can only be accomplished through more frequent informal but agenda-driven meetings directly among the principals. There have been various attempts at this during my 4 years at OTS, but none have been sustained or particularly successful.

I am pleased to say that we are trying again. We had our first breakfast meeting on September 28, and Chairman Powell assures me he has another one being scheduled.

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 resolve the problems themselves, in part out of a respect for the principals, but I suspect in part out of a concern that the principals will not really understand what is at issue. 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. The unfortunate events of September 11 have brought us closer again, reviving some of the spirit of working together we felt in preparing for Y2K. We need more cross-training, more work on each other's examinations, perhaps details into other agencies, and interagency SWAT teams for particularly tough or high-risk issues.

We have made very significant progress on this issue. Within the past month, we have instituted a program of having examiners from several agencies participate in exams of institutions with securitization activity and the first such exam is underway, and there is now a regular monthly interagency meeting to discuss securitization issues. We are laying a groundwork for a marked increase in multiagency participation and exams in 2002.

I have obviously spent my time 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. And I do certainly think that there is room for improvement and we really have started to make improvement and, moreover, have begun to complete actions that had started long before the failure of Superior. However, it is useful to close with the observation that regulatory action can only go so far. The ultimate responsibility for the success or failure of any depository institution rests with its owners and management.

Thank you very much.

Chairman SARBANES. Well, thank you very much.

I just might note that President Bush has nominated James Gilleran of California to become the Director of OTS. And his confirmation hearing will be held on this Thursday, the day after tomorrow. We wanted to get the hearing in with respect to Superior

obviously during your tenure, during your watch, since you are familiar with the situation. But the Gilleran hearing will be on this Thursday.

Mr. Reich, we would be happy to hear from you now.

STATEMENT OF JOHN REICH

DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. REICH. Thank you, Mr. Chairman.

In my oral testimony, I will briefly summarize the issues which I think make the Superior failure a matter of interest to the Congress, the regulators, the industry, and interested members of the public. And I will spend a few moments discussing the lessons I think we have learned from the institution's demise. At the outset, Mr. Chairman, I want to make clear two very important points.

First, America's banking industry is safe and sound. While we have some concerns—regulators, by definition, almost always have some concerns—we are very comfortable with the stability of our financial system and the failure of Superior Bank should be viewed in that context, as an anomaly.

Second, I would like to stress that Superior failed because of its own actions. Its board, its management decided to pursue a risky lending and securitization strategy. By securitizing loans on the riskier end of the spectrum and retaining large portions of that risk in the bank, they pursued a business plan that ultimately led to the thrift's demise.

While much has been made about the supervisory history of Superior and the regulators' handling of this thrift, I want to stress that the bank's owners and managers bear the responsibility for the failure of Superior. That is not to say, Mr. Chairman, that we regulators cannot learn valuable lessons from the events which led to the failure, which should help us in the future.

At the FDIC, we first noticed significant problems at Superior Bank in late 1998. While the thrift was still highly rated, our off-site reviews noticed the bank was taking on more high-risk, subprime assets. We also noted the thrift experienced significant growth in retained interest, often called residuals, and mortgage-servicing assets. It was this volatile combination which ultimately led to Superior's failure in late July.

On the basis of this information, the FDIC did ask to join the Office of Thrift Supervision January 1999 examination. That request was denied.

The FDIC continued to monitor the thrift through off-site reviews and following the January 1999 denial, the FDIC and the OTS, in my view, subsequently worked well together to understand and address the problems presented by Superior.

While the news in 1999 was troubling to the FDIC in our capacity as the deposit insurer, the conditions in 2000 and 2001 did not improve. The risk in the bank continued to grow and the regulators became increasingly worried about how the volatile residual assets were being valued by the thrift.

Serious disagreements about the accounting methodology prevented a timely resolution to this dispute. While the regulators' view ultimately prevailed, the write-down in the value of Superior's

residual portfolio did not occur until March of this year. This $270 million write-down crippled the thrift's capital position.

The OTS, as the primary regulator, requested a recapitalization plan that would have saved the thrift from insolvency. In late May, this plan was finalized and was scheduled to be implemented within 60 days, by late July 2001. Ultimately, the owners failed to implement the plan.

While clearly financially capable of rescuing this thrift, they chose not to do so. The FDIC was appointed conservator on July 27, 2001. Our first priority as the conservator for Superior was to ensure uninterrupted service for the customer base in the Chicago area. The point of the conservatorship, as opposed to an outright liquidation, was to preserve franchise value. Any banker knows the franchise is only as good as its satisfied customer base and we have made that our priority in managing New Superior.

Since July, we have processed more than 60,000 customer inquiries through our call centers and in-person consultations to ensure as little disruption to the community as possible. Taking care of insured depositors is our job and we take it seriously.

We are making progress toward returning Superior to the private sector by the end of the year. Bids for deposits are due October 25. We have finished the initial marketing of the residuals, the loan serving, and loan production platform and final bids are expected in November. What lessons can we learn from Superior's demise? I will mention three.

First, we must do a better job dealing with institutions fitting Superior's relatively new and volatile risk profile. Since 1998, several institutions looking like Superior have failed, with the FDIC incurring more than a billion dollars in losses. We must see to it that institutions engaging in risky lending, securitization, and high retention of residual assets hold sufficient capital to protect against sudden insolvency.

The regulators have offered an interagency proposal requiring dollar-for-dollar reserves against residuals retained within institutions and a limit on the overall amount of residuals any one institution may hold. We expect a final rule will be published in the *Federal Register* in late November. As the protector of the insurance funds, the FDIC believes it is important that we find a way to ensure that banks hold additional reserves against such volatile assets.

Second, Superior taught us a lesson about the effectiveness of the prompt, corrective action guidelines currently in the law. PCA appears to be sufficient for handling all but a few troubled bank cases. It is less effective in the handling of instances where institutions suffer sudden shocks, like cases of fraud or large write-downs of asset values.

Under the current PCA statute, the FDIC cannot take separate action against non-FDIC-insured institutions until the institution becomes critically undercapitalized. In cases like Superior, when the institution becomes impaired very quickly, this constraint prevents us from having time to take meaningful, independent action to minimize the risk to the funds. The FDIC believes that deposit insurers should have additional authority under PCA rules to in-

tervene before a non-FDIC-supervised institution becomes critically undercapitalized.

The last lesson to be learned and perhaps the easiest one to resolve is the need to improve FDIC access. While some of the post-Superior discussion focused on the relationship between the OTS and the FDIC, the plain truth of the matter is that both agencies worked well together for more than 18 months dealing with a very troubled institution.

It is also fair, however, to point out that two sets of eyes earlier in the process might have mitigated a portion of the loss to the insurance funds. In part, this is a shortcoming of the FDIC board's own internal procedures.

We intend to review—in fact, we are reviewing—whether our own board's special insurance examination policy is inhibiting our ability to determine the risk which non-FDIC-supervised institutions pose to our funds.

All of these lessons are important.

In conclusion, I appreciate the opportunity to represent the FDIC here today. I look forward to working with you and our fellow financial regulators to implement these necessary improvements.

I will be happy to answer questions.

Chairman SARBANES. Thank you very much, sir. We appreciate your testimony. I first want to focus on this regulation that we are now assured is about to happen.

After Keystone Bank failed in September 1999, 2 years ago, and that resulted in losses of close to $800 million, the Federal banking regulators in September 2000, promulgated a proposed rule to impose stricter capital rules and limit the concentration of residuals, is that correct?

Ms. SEIDMAN. [Nods in the affirmative.]

Chairman SARBANES. That was a little over a year ago. The comment period for the proposed rule closed on December 26, 2000, about 10 months ago. And as yet, there is no final rule.

Now in a letter to the regulators, they indicated to us, ". . . for the last 8 months, the agencies have been working to balance the industry's comments with supervisory concerns."

I know you are now assuring us you are going to get this rule in the near future. But I am interested to find out why it took so long to get to the rule, accepting the assurance for the moment that the rule is about to come.

Let me say that I obviously have some quizzical response to that given the past record. As you prepare to answer that question, I want to read from a comment letter in which a thrift president complained that the proposed capital requirements in the new rule—this is a comment during that comment period after you put out the proposed rule—". . . would impose stringent capital limits and penalty capital requirements on institutions whose practices do not warrant any such treatment."

That letter adds that the thrift has a proven track record and, ". . . depth of expertise in securitization activities. . . ." We have done so without taking on undue liquidity, credit, or interest-rate risk. Now that was a letter submitted during the comment period on December 22 of last year and the letter obviously came from Superior Bank. Now why has it taken so long to move on this rule?

Ms. SEIDMAN. Let me answer that question in a couple of ways.

First of all, the comment letter from the Halloran was by no means the only comment letter that read like that. And as to the representations Mr. Halloran made in that letter, those were representations that were already under serious question by both the OTS and the FDIC at the time he wrote the letter.

In terms of the interagency process, the interagency process is a difficult process. While the residual rule has taken 8 months, the recourse and direct credit substitutes rule has taken 8 years. It is a difficult process in part because each regulator looks at things slightly differently. We need to work together. We need to work hard to ensure fairness across a wide range of institutions and, in the case of the residual rule, we had to make sure that its very technical requirements did not conflict with the even more technical requirements of the recourse and direct credit substitutes rule which deals with a greater part of the same issue.

My staff in 1998, when bank regulators adopted limitations on purchase credit card relationships, nonmortgage servicing rights, and mortgage servicing rights, was pressing very hard for limitation also on residuals. It is part of the interagency process that it did not happen then. I am sorry it took the failure of Superior to move it along now, but it has moved along and it will be final.

Chairman SARBANES. When was the proposed rule put out on the recourse rule?

Ms. SEIDMAN. There have been several proposed rules. There was one in 1993. The most recent proposed rule was, I believe, in 2000, but I am not sure. Can I just ask my staff?

[Pause.]

Sometime in 2000.

Chairman SARBANES. Well, on the residuals the agencies were able to get together within a year's time and propose the rule. Is that correct?

Ms. SEIDMAN. Senator, it is much easier to get together on a proposal than it is on a final rule, frankly. On a proposal, while you do a lot of work to reconcile different perspectives and different ways of looking at things and making sure you have it right, you know that the comments coming back will help you sharpen your pencil and help you sharpen the rule when it finally becomes final. Moreover, a proposal is not binding on the industry. So there is a lot more flexibility to get to yes on a proposal. The final rule is really what counts and what is so difficult.

Chairman SARBANES. Now when you got this comment letter, you had already focused on Superior as a real problem case?

Ms. SEIDMAN. Oh, certainly, sir. As you know, the focus on Superior started in early 1999. By late 1999, both the FDIC and the OTS were very seriously concerned with the institution and——

Chairman SARBANES. When you got this letter, did it heighten your concern about Superior?

Ms. SEIDMAN. It did not particularly heighten our concern. We knew that—first of all, it was a comment letter on a regulation. The issues that Mr. Halloran raised in those letters were issues we were already aware of and concerned about. By not very many months after that letter was written, Superior's CAMELS rating was dropped to a "4" by both institutions.

Chairman SARBANES. And the fact that you had the president and managing officer telling you in December everything is just terrific here in the course of arguing against your proposed rule, did not move you to quicker action?

Ms. SEIDMAN. I think we acted quite quickly. The next examination started in January and at the time it ended——

Chairman SARBANES. Now is that the examination that the FDIC participated in?

Ms. SEIDMAN. Yes, that was the January 2000 examination that the FDIC participated in.

Chairman SARBANES. The one where you were turned back.

Ms. SEIDMAN. 1999.

Mr. REICH. 1999.

Chairman SARBANES. 1999.

Ms. SEIDMAN. January 1999. And by May 2000, when that exam closed, both the FDIC and the OTS had rated Superior a "4".

Chairman SARBANES. Now am I correct that a failure of another institution somewhat with the amount of loss, somewhat larger than is now being estimated for Superior, would bring the fund ratio below 1.25 percent and trigger the fees?

Mr. REICH. No, sir, that is not correct. Of course, at this moment, we do not ultimately know what the final cost of the Superior resolution is going to be. We have reserved currently approximately $300 million for Superior. The asset sales that are scheduled to take place later this month and in November will diminish the loss. But the BIF is currently at a ratio of 1.32, 1.33. The SAIF is at 1.40. And we do not believe that the loss will bring the ratios down below 1.25.

Chairman SARBANES. How much more of a loss would the SAIF have to experience to go to 1.25 and trigger the fees?

Ms. SEIDMAN. The number has to be more than double, well more than double the amount.

Mr. REICH. It would be a very large number and we do not anticipate being at that level any time in the near future.

Chairman SARBANES. What would the number be? We must know what the number is.

Mr. REICH. I believe each basis point would represent about a $17 billion charge to the fund. So to lower the fund from its present level, the BIF from 1.32 to 1.25, 7 basis points——

Chairman SARBANES. Would be about $800 million, would it not?

Ms. SEIDMAN. I think you have the BIF and the SAIF confused.

Chairman SARBANES. No, I am doing the SAIF.

Ms. SEIDMAN. Yes. The BIF has a lower capitalization right now than the SAIF.

Chairman SARBANES. Right.

Ms. SEIDMAN. The SAIF is at 1.40. So it is 15 basis points above 1.25. A portion of the Superior loss is already in the reserves that are counted into the 1.40. To get to 1.25, you are probably going to need an additional $1.5 billion loss, give or take, and none of these numbers, mind you, include any recover from parties who we believe should be the subject of enforcement action.

Chairman SARBANES. Well, we will check these figures out. I have a different set of figures that I am looking at, and we need

to ascertain those. And we will probably give you some follow-up questions in that regard.

Mr. Reich, in an article you wrote in *The American Banker* in August, you said about 1½ percent of insured institutions have significant subprime portfolios. Yet, these lenders represent about 20 percent of the banks on the FDIC's problem bank list. We regulators must make sure these lenders hold enough capital to cover the risks they face.

In *The Washington Post,* in an article entitled, "A Practice That Lends Itself To Trouble," it said, of the hundred banks on the problem bank list, 15 are subprime lenders. Seven of the 21 bank failures since January 1998, were institutions, including Superior, that were involved in subprime lending. What can the panel tell us about the risks associated with subprime lending?

Mr. REICH. Well, first of all, I would say that subprime lending in and of itself is not a bad activity for banks to be engaged in. That is how many banks satisfy their Community Reinvestment Act requirements. Most banks have lending officers well qualified to make loans that would be categorized as subprime loans and in and of itself, it is not an activity that should raise concern.

But when there are targeted programs that require special expertise, the regulators have a responsibility to make certain that the people in those institutions are managing those activities appropriately and that the banks have capital requirements that take the additional risks that are attached to subprime lending into consideration.

As those articles indicated that you quoted, we have about 100 banks on our problem loan list at the present time, and of those 100 banks, about 20 are institutions that are engaged in subprime lending. And the most recent statistics regarding the number of institutions which have been failed, you mentioned 7 in 21, it is now 8 of 22 institutions that have failed, have been significant subprime lenders.

Ms. SEIDMAN. I agree with what Director Reich has said, although I would point out that one can meet one's CRA obligations with prime lending also. But it is important that we recognize a couple of things here.

One is that it is not just subprime lending that is at issue here, although subprime lending, particularly when done in a program form, which is what our guidance in March 1999, January 2001, and then the Q and A's in August this year, are all about, does require substantially better expertise, risk management, reserving, and capitalization, than a similar business done on a prime basis.

What you had here and what a number of other subprime failures have involved is a combination of subprime lending, then securitization, and then residuals. That is why it is so critically important for us to get at this residual issue, because it will really help us make sure that the capital that is held against subprime loans is real capital.

Mr. REICH. If I could, Mr. Chairman, I would like to add, one of my concerns that I expressed in the op-ed, or that resulted in the op-ed, was that when the interagency guidance was issued on subprime lending, we distributed it to 9,700 insured institutions, at a time when there were approximately 150 insured institutions en-

gaged in subprime lending, subsequently, arousing the concerns of several thousand bankers concerned about whether the types of loans that they make in the normal course of business, many character loans that every bank makes every day of the week, would be categorized as a subprime loan and would jeopardize or make the bank exposed to having to maintain a capital level of perhaps up to 3 times their normal capital.

At the FDIC, at our outreach efforts, and at our meetings with delegations of bankers who come for briefings at the FDIC, we have tried to assuage their concerns that the interagency guidance was intended for a narrow group of banks which have targeted lending programs specializing in subprime lending.

Chairman SARBANES. Professor Kaufman, who is going to be on the next panel, in his statement submitted to the Committee, says that in the case of Superior, a number of red flags were flying high that should have triggered either a rapid response by regulators or continuing careful scrutiny.

And he then mentions Superior's rapid asset growth from 1996 to 2000, a large percentage of risky, nontraditional assets, such as residuals. Superior held more than 7 times the residual assets of any other savings institution, as this chart shows.

This is Superior and these are the other—well, I have a big one here. It is a pretty dramatic contrast.

Ms. SEIDMAN. When is this? I am sorry.

Chairman SARBANES. That is Superior over there on the left, and these are——

Ms. SEIDMAN. Excuse me? What period is this?

Chairman SARBANES. This is in March 2001. A year earlier, they held residuals in excess of 300 percent of Tier 1, and 2 years earlier, they held 200 percent.

He also mentions well above market rates Superior offered on deposits, including broker deposits, and the high percentage of off balance sheet recourse obligations held by Superior. Now, at what point did these red flags attract your attention?

Ms. SEIDMAN. I would say they attracted the FDIC's attention at the end of December 1998, and attracted our attention soon after. We actually were first—we were initially concerned about the automobile program, which is another subprime program, which we eventually got them to shut down in December 2000.

Professor Kaufman is absolutely right. But what is also clear is that the enhanced scrutiny and action that he was talking about was happening. There was definitely enhanced scrutiny in this institution from at least mid-1999 on. This is easily lost because as the institution had to take greater capital hits because of revaluation or increased loan loss reserves, the percentage of residuals kept going up. But by June 2000, we had gotten the institution to cease securitizing. And it therefore was creating no additional residuals. The percentage kept going up because the capital kept going down. But the institution was creating no new residuals.

We had worked with them to put a number of limitations on their activities. The auto activity in particular was stopped, to improve their underwriting, to stop some of what they were doing.

In July 2000—this is a year before the institution failed—we told them to stop taking brokered deposits, which they did. They were

able to hold onto the ones they had, but they could not renew brokered deposits and they could not take new ones. This, by the way, is part of the reason for—this plus the way Superior reported its uninsured deposits—the precipitous drop-off in uninsured deposits that I know Mr. Ely has talked about.

By late 2000, both the FDIC and the OTS not only were working with Superior under Section 39 of the FDIA, which is a much more flexible section than PCA in a situation where reported capital is higher than it should be, but there are problems. And that is what we were working under, when we got in, the 2000 audit report.

Superior's financial year ran from June to June. The June 2000 audit report was delivered in October, at which point both the FDIC and the OTS started pouring over not only the audit report, but also all the work papers. It was at that point that we realized notwithstanding the representation that the overcollateralization accounts were being accounted for properly, they were not. It was not until January 2001, however, that we could get a national partner at Ernst & Young to agree with that conclusion. At that point, the write-downs were very large and as Director Reich pointed out, what had been a problem that could have been solved suddenly became a very precipitous problem.

Now this problem still could have been solved. The people who own this institution not only have the resources to solve the problem, but also had promised to solve it, and then walked away a mere week before the deadline, making it impossible for us to find an alternative solution.

Chairman SARBANES. Well, an article in—and I want to give you a chance to respond to all of this because there is a lot out there in the press—*The National Mortgage News,* in August of this year, entitled, "Residual Mess Kills Superior," quotes an investigator who said, "The OTS knew about the poor assets on Superior's books since last July. Why did they sit on their haunches and diddle with Ernst & Young for 6 months arguing about what they, the residuals, were worth, and then diddle another 6 months negotiating with the Pritzkers?" How do you respond to that?

Ms. SEIDMAN. Whoever wrote that had what in August was a perfectly understandable distorted view of the facts. It was less than a month since the failure and the facts have really only begun to come out, in part, as a result of this hearing and many, many, many more facts will come out as part of our enforcement investigation and the other actions, the other investigations that are going on.

It is clear from my testimony that we did not sit on our haunches and diddle. We took a whole series of regulatory actions and any number of them were indeed successful. As I have said in my oral statement today, if I had to do it over again, the one thing I would have done is not get more promises from the management and board of this institution, but work more diligently at making sure they actually implemented what they had agreed to implement.

As to the capital plan, the plan would have infused a very—hundreds of millions of dollars—significant amount of money, into this institution. It was a capital plan that was backed by people who were perfectly capable of proceeding with it. The fact that they

chose to walk away a week before the date they had promised to implement it—mind you, this was a sudden move on their part.

Until July 16, the capital plan had a number of other things that were required. Shedding employees, closing unprofitable business lines, negotiating with Greenwich Capital for some financing. All of that was happening. The capital plan was being implemented. And then the owners walked away.

I do not regard that as diddling. I regard that as unfortunate and I regard that as something that will be discussed in a number of investigations and enforcement actions.

Chairman SARBANES. Well, now, Mr. Ely, in his statement, which comes later, states that the OTS failed to recognize a fundamentally flawed business model Superior adopted when it acquired Alliance Funding at the end of 1992. Instead, the OTS appears to have permitted Superior to pursue that model for over 8 years until its closure on July 27.

The linchpin of Superior's flawed model was retaining the worst portion of its asset securitizations. Hence, we see the steady build-up of dubious, nonmainstream thrift types of assets on Superior's balance sheet. Worse, it appears that these assets were consistently overvalued for many years.

Had the OTS taken a greater initiative to independently establish conservative valuations of Superior's securitization-related assets, Superior would have been forced to adopt a more profitable business model or sell itself to a stronger financial institution. And he makes the point that the failure of the First National Bank of Keystone should certainly have set off alarm bells and that there was a failure to appreciate the extent to which Superior was an outlier among thrifts. It was far from being the typical post-FIRREA thrift. What is your response to that?

Ms. SEIDMAN. My response is that this is a case of rather gross overstatement.

First of all, mortgage banking, which was Superior's baseline business plan, is a common business plan not only in the thrift industry, but also in the banking industry, and it is becoming more so, and in fact, has kept the thrift industry healthy during the period of low flight yield curve that we had several years ago. So the basic model of mortgage banking is not flawed.

Chairman SARBANES. Let me continue on that point. Mr. Ely says, for example, at the end of 1997, almost 4 years before Superior failed, it had almost 7 times—seven times—as much invested in the asset categories containing securitization-related assets per dollar of total assets as did the rest of the thrift industry.

Ms. SEIDMAN. Senator, I am not going to argue with Mr. Ely's point that this was an outlier. It was.

Chairman SARBANES. Well, why wasn't it——

Ms. SEIDMAN. I am going to argue that at least beginning in 1999, we were very much on top of it. We were moving it to shrinkage. We had stopped by the middle of 2000, the creation of new residuals. And we had some extraordinarily wealthy people agreeing that they would put this institution whole.

Chairman SARBANES. Let us take 1997. This is the figures I am giving you now.

Ms. SEIDMAN. No, I hear you.

Chairman SARBANES. And the assertion behind this statement is that, as he says here, even a rudimentary comparative analysis of Superior's TFR data with thrift industry data should have flagged it as an outlier worthy of special attention years before it failed.

Ms. SEIDMAN. Senator, whether it should have flagged it in 1997 is something I guess we can argue about now.

What I know is that a full 2½ years before this institution failed, at a time when the problems were a good deal smaller, we were aware of it. And I would like to read you, one of the other things that Mr. Ely does in his testimony is talk about how the private sector was on top of this and really was far ahead of the regulator.

In May 1999, at a time when the OTS and the FDIC were downgrading this institution to a "4", here is what Fitch, which rates the institution's long-term debt a triple B, which is investment-grade, had to say about how Superior accounted for residuals.

Important to evaluating the company's performance is our assessment that Superior uses appropriate assumptions in recognizing FAS 125 income. That is scale on sale income. Furthermore, the company's process for valuing related financial receivables, recognizing adjustments on a quarterly basis when applicable, is viewed positively.

This was May 1999. We did not downgrade it until May 2000. But by May 1999, both we and the FDIC knew there was an issue here, and it was an issue, at the very least, of concentration and perhaps of valuation. It is always easier to see these things in hindsight.

Chairman SARBANES. That is quite true, but the question then becomes, as we are trying to think ahead for the future, if you are sitting there telling us, we did everything right, and even here a couple of years just before the thing fell flat on its face, we started to move, what does that say about our process? Are we going to have another Superior that comes down the road the same way?

It seems to me you had all kinds of signals that this outfit was outside anything approximating a normal parameter for activity in the industry. That seems to me very apparent. And yet, it went along until it got to desperate straits.

Ms. SEIDMAN. Senator, I do not disagree with you. And in fact, as Mr. Ely also mentions in his testimony, there was another institution, another thrift that was in similar straits at approximately the same time. We were able to successfully work with the owner of that institution to have a voluntary liquidation, a liquidation which occurred with no loss to the insurance fund, no loss to uninsured depositors. Mr. Ely mentions it, never mentions why that institution had a voluntary liquidation.

Senator, our track record is not perfect. The people who owned this institution, much to our surprise, walked away from it after having promised to put it back together again. But it is a track record I am proud of and that I am pleased to leave my successor.

Chairman SARBANES. It is not an adequate response to a particular problem situation to say to me, we have done well in all these other instances, if, in fact, you were deficient in handling this instance.

Ms. SEIDMAN. Senator, I have agreed with you.

Chairman SARBANES. It is relevant to saying, this agency is not a complete flop. But I am not asserting that and that is not what we are trying to get at. But for you to sit there at the table and then say, we did the other things right, but we did not do this thing right, what can we do about this thing that was not done right to make sure that it does not happen again?

Ms. SEIDMAN. Senator, I have a couple of responses to that and I am pleased to hear you say that it is not the agency's overall record that you are going after.

Chairman SARBANES. I am not going after anything. I am just trying to find out what we can do to improve this situation. You do not have to be overly defensive. Just try to address that aspect.

Ms. SEIDMAN. The first thing is, as I have mentioned in my testimony, there are a number of things that we are doing. Given that the problem is this combination of heavy investment in subprime, securitization, and residuals, the new regulation should make a major difference and, moreover, the programmatic subprime guidance that we issued should also prove extremely helpful. So there is activity that is going on, and it is all described in both my written statement and my oral statement.

Chairman SARBANES. Why did the OTS deny the FDIC's written request to join the OTS in the examination of Superior in January 1999?

Ms. SEIDMAN. Senator, the reason that the OTS regional office, and this was an action that was carried out entirely between the FDIC and the OTS regional offices in Chicago. No one at either institution in Washington knew what was going on. The reason related to Superior's concerns that they had ongoing litigation with the FDIC.

Would I have made the same decision at that point? I hope not. And when it came to my attention in September 1999, after the Keystone failure that we had in fact once denied a request—and mind you, even the FDIC IG has not found any other instance in which we did that—my immediate reaction was to say to all of my regional directors, you do not do that. And if you have any reason why you think it might be a good idea to do that, you have to get that up to Washington so we can talk at a Washington level about whether this makes any sense at all.

It has never happened since. The work that we are doing in this task force, which includes my senior supervisory people, as well as the senior supervisory people from the FDIC, the OCC, and the Fed, will ensure that a new protocol is in place so this issue will not arise again.

Chairman SARBANES. Mr. Reich, what authority do you think the FDIC should have to go in and join in an examination?

Mr. REICH. Well, frankly, Mr. Chairman, under ideal conditions, I would like for the FDIC to have the authority to go into any institution regardless of its CAMEL rating, whenever we believe that there are reasons that may develop that could subject the FDIC fund to exposure.

Chairman SARBANES. Do you have a problem with that, Ms. Seidman?

Ms. SEIDMAN. That is a standard that is—as stated, and I suspect that Director Reich does not really mean to put quite so many

qualifiers on it—it is a standard that would lead to the possibility of the FDIC being in thousands of institutions in this country.

The CAMELS ratings are not necessarily dispositive of the issue of whether there is risk to the insurance fund. And that is what we are working on in the renegotiation of this protocol, which, as I said, includes all four agencies, not just the two of us.

Chairman SARBANES. So, you would not allow them to go in if they judged——

Ms. SEIDMAN. No, it is not that I——

Chairman SARBANES. —that there was a reason to go in.

Ms. SEIDMAN. If they judged that there was a reason to go in, yes, we would say, yes.

Chairman SARBANES. Then what was wrong with his statement?

Ms. SEIDMAN. I believe Director Reich's qualification was, if we thought there might be a possibility of a risk. That is further away than we think there may be a problem here. Let us go in and take a look. But, you know, Senator, I believe that when this protocol is finished, all four agencies will feel very comfortable with it, including the FDIC, and it will not get finished if the FDIC does not feel comfortable with it.

Chairman SARBANES. When is that protocol going to be finished?

Ms. SEIDMAN. Well, we were hoping to get it done by the end of the month. There is a little bit of hold-up now. I just heard about that this morning. Since I firmly believe that this is one of those situations where if you tell the senior people who have to live with this year after year, and get it done in a way that the kind of problems that arose in this case will not arise again, they will, I have left it to them and am awaiting their response.

Chairman SARBANES. We are very interested in that protocol.

Ms. SEIDMAN. And it will be arriving.

Chairman SARBANES. We are interested in, partly, why it has taken so long, and of course, we are interested in the substance of what the rule will embrace.

Ms. SEIDMAN. One important element of it is that the last one did not include the Fed. The same issue arises with respect to State member banks as does with OTS or OCC regulated institutions. So that by adding the Fed to the discussion this time, we will end up with something much stronger.

Chairman SARBANES. Is there anything else you want to add?

Mr. Reich.

Mr. REICH. Yes. I would like to review a little history with respect to the current rules under which the FDIC board operates.

It was, in 1995, during a time when the FDIC board was composed of just three members—the FDIC Chairman, the OCC Comptroller of the Currency, and the Director of the OTS—there was a board resolution passed by a vote of 2 to 1, which prohibited the FDIC from exercising back-up examination authority unless it was brought to the attention of the board of directors of the FDIC.

This had an inhibiting impact on our ability to engage in back-up examination authority. And it is always a risk that will exist as long as the board is composed of members, of the current membership of the board and jeopardizes the FDIC when we do not have a full board and places the Chairman of the FDIC potentially

at a disadvantage, unfortunately, in instances that could only be described as turf wars, with the other regulators.

Chairman SARBANES. Yes, what is the problem with the FDIC coming in and engaging in an examination if they think there is a problem? I am asking Ms. Seidman. What is the problem with that?

Ms. SEIDMAN. If they think there is a problem, there is no problem with them coming in. The issues that we are dealing with are issues that are fairly important. How many examiners? When? Do we go in together? Do we issue a joint examination report? What is the role of the primary regulator in dealing with the board of directors? Because in the old days, in the pre-1995 days—and I was not here—there was difficulty in that respect.

Chairman SARBANES. What was the difficulty?

Ms. SEIDMAN. The difficulty arose when the FDIC, in a training mission, sent 27 examiners into a small institution, or when the FDIC met with the board after the OTS met with the board. There are things that can be solved by people of goodwill. And the reason why going back to this 1995 protocol is so troubling to me, is I have sat on the board of the FDIC now for 4 years. I have been an extremely active member of that board. I have sat on the FDIC audit committee for 4 years, a rather thankless job.

I believe in the FDIC every bit as much as I believe in my own organization. I have sat on the FDIC board with a full 5 member complement. I am sorry the staff feels intimidated because I really do not believe that they should or need to. Frankly, it is the non-independent board members who would never in a board case brought by the FDIC staff to take independent regulatory action, say no at the board level.

I wish there had been a full FDIC board all the time that I was there. It was good while it was there. And the 5 member board is terrific. But, unfortunately, that tends to be dependent on a lot of other things, including the whole Presidential nomination process.

Chairman SARBANES. Do your regional people have the authority to keep the FDIC out?

Ms. SEIDMAN. No, absolutely not. That is what I said earlier, that as soon as I found out——

Chairman SARBANES. Well, they must have had the authority because they did it. You had your regional people in Chicago. The FDIC people wanted to go in and participate in the inspection, as I understand it. Is that correct?

Ms. SEIDMAN. That is correct.

Chairman SARBANES. The OTS regional people said, no, we are not going to let you come in. Is that right?

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

Now, do I think that that was a great solution? Certainly not in hindsight, and I hope I would not have then.

Chairman SARBANES. Do you think your regional OTS people in Chicago should have had the authority to deny the FDIC request?

Ms. SEIDMAN. They did not in fact have the final authority. If the FDIC regional office in Chicago had brought that to Washington's attention, there would have been conversations and something else would have happened.

What we are saying now is we are not leaving it to the regional offices who have to work together day after day on issue after issue, to have to take an appeal. We are saying, no, you cannot deny it at the regional level, period, end of issue. If you are even thinking about it, it needs to go to Washington. We do not want to force the FDIC regional offices, who have to have a good working relationship with the regional offices of the other regulators, into an appeal position.

Chairman SARBANES. What is the OTS position today—let me quote a statement of yours in a hearing before the House Banking Committee in February 2000. "We have one policy . . . the door is always open. We have told our regional directors that whenever the FDIC asks to go into a thrift, that request must be honored. A second set of eyes is a benefit when an institution is showing signs of stress. And in numerous instances, we have sought out FDIC participation in examining a problem institution."

But the first sentence here is, ". . . we have told our regional directors that whenever the FDIC asks to go into a thrift, that request must be honored." Is that your position?

Ms. SEIDMAN. That is exactly our position. That is our position, that statement was dated February 2000.

Chairman SARBANES. February 8, 2000.

Ms. SEIDMAN. Right. It came after Keystone. It came after I found out for the first time in September or October 1999, that there had been a denial in January 1999.

Chairman SARBANES. Then how do you differ with Mr. Reich a little earlier in this conversation we were having when in fact you now say, "We have told our regional directors that whenever the FDIC asks to go into a thrift, that request must be honored?"

Ms. SEIDMAN. The only way I am really differing with Mr. Reich is that Mr. Reich's initial standard that he set forth was a standard that I suspect the FDIC would not, in fact, use in deciding whether to go into an institution. The FDIC's standard is, in fact, are we concerned that there may be a problem here? And when they use that standard, the answer is yes.

Chairman SARBANES. Well, we have the other panel. We have to move along. We are interested in finalization of this regulation.

Ms. SEIDMAN. It will happen.

Chairman SARBANES. We intend to follow that very closely. And we may well hold further hearings on this issue. But we have to tighten up this protocol. My reaction to all of this, both the written testimony and the factual examination and this examination today, is that the protocol is lacking.

Ms. SEIDMAN. It is. That is why we are working on it. It will be tightened up and it will include the Fed this time.

Chairman SARBANES. Mr. Reich, anything else you want to add?

Mr. REICH. Well, I would echo your comments about the importance of updating the capital rules with respect to residual assets. There are today about 10 institutions which have 25 percent or more of their capital in subprime residuals. We are closely moni-

toring those institutions and do hope that by the end of November this rule is, in fact, published in the *Federal Register*.

I would want to emphasize that the FDIC in no way wants to examine all the banks in the country all the time. We do not have the staff, the resources, or the capability to do that. What we do want to do is to examine those banks that we think bring potential risk to the insurance fund. There may have been instances in the past—I am not aware of them, but I would not dispute that they occurred—where we have put too many examiners in a bank in a given situation. And my experience with the FDIC in the past 9 months, what I have seen on the part of our supervisory people is a desire to have a small number of people, and in some cases, one or two, in given situations to explore particular problems.

That was our original intention with Superior in December 1998, when our capital market specialist identified the increasing problem with residual asset growth on the balance sheet of Superior Bank, and our intent would have been to send one or two people—this is hindsight testimony at this point—had we joined the January 1999 examination.

Chairman SARBANES. Thank you all very much.

If the other panel would come and take their places at the table, we will proceed in just a couple of moments.

[Pause.]

First of all, I want to thank the witnesses for their patience and for their coming back to be with us again. We have three experts on the banking industry with us: Mr. Bert Ely, the President of Ely & Company of Alexandria, Virginia; Dr. George Kaufman, who is the John F. Smith, Jr. Professor of Finance and Economics at Loyola University Chicago; and Karen Shaw Petrou, the Managing Partner of Federal Financial Analytics here in Washington, DC.

We very much appreciate your being with us. We have your full statements, and, of course, those will be included in the record.

If you could summarize, I will go across the panel, take each of your statements. We ran a little long with the other panel, for obvious reasons. So, if you could compress it, we would appreciate that.

Mr. Ely, why don't we just start with you and we will move across the panel to Dr. Kaufman and Ms. Petrou, you will be last but not least, I assure you.

STATEMENT OF BERT ELY

PRESIDENT, ELY & COMPANY, INC.

Mr. ELY. Mr. Chairman, thank you very much for the opportunity to testify today. I have prepared an oral statement, but in the interest of time, I will condense that down by skipping over the first portion of it and touching on what I see as the failures of the regulators and, specifically the OTS in the Superior situation, as well as my recommendations for future legislative action.

Some of this you picked up on yourself in your questioning of the previous panel. But what is important to emphasize is that the OTS did fail to recognize the fundamentally flawed business model that Superior adopted back in 1992, when it acquired Alliance. Key to Superior's flawed model was retaining the worst portion of its asset securitizations. But also, again, as you mentioned, the OTS

apparently failed for years to appreciate the extent to which Superior was an outlier among thrifts.

It was far from typical, almost from the very beginning. But also, Superior did not reserve adequately for future loan charge-offs and asset write-downs, constantly causing its capital to be overstated. It also relied heavily on nonretail deposits, including brokered deposits, to fuel the growth and funding of its securitization-related assets.

Especially troubling was its gathering of uninsured deposits and what I found particularly troubling is the fact that even after it was well known that Superior was on the edge of failure, that uninsured deposits were allowed to grow by $9.6 million in the second quarter of this year.

Another problem that Ms. Seidman does address in her written testimony, but I still find astounding, is the extent to which Superior was filing flawed and clearly erroneous thrift financial reports to the OTS. This constituted the only publicly available information on the institution which would impair the ability of uninsured depositors and other creditors to properly assess in a timely way the financial condition of Superior.

Also, I do not think the FDIC is blameless, either. Although it raised concerns about Superior in late 1998, the question I would pose is, did the FDIC pound the table hard enough about Superior's declining condition? Frankly, I doubt it. Also, the FDIC appears not to have developed a "Plan B" to execute if the Pritzker/Dworman recapitalization plan for Superior fell through. This unpreparedness is evidenced by the fact that the FDIC had to place Superior in a conservatorship, in my opinion, will add to its insolvency loss.

Turning to some broader regulatory issues, there have been 35 FDIC-insured bank and thrift failures since the beginning of 1995. Three of them—Superior, Keystone, and BestBank—account for $1.8 billion, or about 87 percent of the FDIC's losses, since 1995.

The loss amount in these three failures is so high because the insolvency loss percentage in these failures is high, ranging up to 78 percent in the Keystone caper. Despite the regulators' best efforts, though, there will be the occasional failure of small institutions, the "fender-benders" of deposit insurance. Of the 35 failures since 1995, 23 were fender-benders. In my opinion, they do not represent a major public policy concern.

Whenever we see a high-loss percentage, that strongly suggests the regulators moved far slowly in resolving a failing institution. Rather than trying to save a bank to keep it independent, regulators should become much more aggressive in forcing weak institutions to merge into stronger institutions or to liquidate prior to insolvency. In light of the recession triggered by the September 11 terrorist attacks, it has become even more imperative than ever that regulators move quickly to resolve troubled banks and thrifts. Let me just close by moving on to some specific legislative recommendations.

First, there has to be more frequent and conservative valuation of risky assets by the regulators.

Second, the bank regulatory agencies need to develop their own capabilities to detect fraud and to value all types of bank assets. It is inexcusable for the regulators to constantly try to lean on and,

frankly, pass the blame to the outside accountants. The outside accountants do not work for the Government. They do not work for these agencies. The agencies need to be able to act independently on their own.

Third, it is not necessary to raise the capital standards for intervention under Prompt Correction Action, as raising those trigger points by a few percentage points will do nothing to prevent bank failures with high-percentage losses.

Fourth, the FDIC should levy losses above a certain percentage of a failed institution's assets on the State or Federal chartering agency for that institution, since it is a chartering agency that, in the final analysis, makes the closure decision.

Fifth, there need to be tough sanctions and even job terminations for high-level personnel in the agencies responsible for supervising a failed institution with a high-loss percentage.

Sixth, I agree with Director Reich that the FDIC's intervention powers should be strengthened, particularly when off-site monitoring suggests a lower CAMELS rating than the chartering agency has established.

Seventh, it is also important to give the FDIC greater power to force the closure of State-chartered institutions. That is an issue that was not present here, but it did come up with regard to the BestBank situation.

Eighth, it is also important to recognize that sufficiently high, risk-sensitive premiums would provide weak banks with a powerful financial incentive to recapitalize or to sell before insolvency is reached.

Ninth, I am troubled that the FDIC seems to back away from the notion of charging weak institutions the premiums that they should be charged. The FDIC has been exploring the idea of relying upon reinsurance premiums to establish risk-sensitive premium rates for large banks. I do not think that that is feasible since a reinsurer must not only take into account a bank's insolvency risk, but also the greater risk that the chartering agency will move too slowly to close a failing bank.

Finally, it is important that there be public notification that amended thrift financial reports and bank call reports have been filed with the regulators to alert depositors and outside analysts to a possible decline in a bank's financial condition because of the amended return.

In closing, the Superior Bank failure is quite troubling, coming on the heels of the unnecessarily expensive Keystone and BestBank failures. Congress needs to probe deeply, as you have been doing today, into the regulatory failings underlying these failures and to respond to their causes and not their symptoms.

Mr. Chairman, I thank you and I welcome your questions.

Chairman SARBANES. Thank you very much. That was a very helpful statement and we very much appreciate the care and the thought that went into it.

Dr. Kaufman.

STATEMENT OF GEORGE G. KAUFMAN, Ph.D
JOHN F. SMITH, JR. PROFESSOR
OF FINANCE AND ECONOMICS
LOYOLA UNIVERSITY CHICAGO

Mr. KAUFMAN. Thank you, Mr. Chairman. I will summarize my long written statement which I submitted for the record.

Chairman SARBANES. Yes, the full statement will be included in the record.

Mr. KAUFMAN. What is important is not so much that Superior failed—bank failures have been infrequent in recent years and inefficient or unlucky banks should be permitted to exit the industry in order to maximize the industry's contribution to the economy—but the exceedingly large magnitude of its loss to the FDIC. As you have noted, this loss has been estimated in the press to be somewhere between $500 million and $1 billion, or 20 to 40 percent of the bank's assets at the date of its resolution. Recent changes in the Federal deposit insurance system have greatly reduced the Government and taxpayers' liability for losses to the FDIC from bank failures by requiring near-automatic and near-immediate increases in insurance premiums to replenish the fund whenever the FDIC's reserves fall below 1.25 percent of insured deposits. In this way, the system is effectively privately funded. Nonetheless, because bank failures are widely perceived to be more disruptive than the failure of most other firms, and the larger the loss, the greater the potential for disruption, bank failures are still a public policy concern and an important public policy issue.

Congress enacted the FDIC Improvement Act, or FDICIA, in 1991 to reduce both the number and, in particular, the cost of bank failures through Prompt Corrective Action, PCA, and Least Cost Resolution, LCR.

PCA specifies sanctions that first may and then must be imposed by the regulators as a bank's financial condition deteriorates in order to turn the bank around before it becomes insolvent with possible losses to the FDIC. The sanctions are triggered primarily by declines in bank capital ratio. But PCA is intended to compliment, not to replace, the regulators' other supervisory techniques that rely on other signals of a bank's financial condition. FDICIA has an explicit section entitled, "more stringent treatment based on other supervisory criteria." Indeed, PCA was introduced not because regulators tended to react too quickly to developing bank problems, but too slowly. Thus, regulators are not required or even encouraged to delay corrective action until the capital tripwires are breached.

Because of confidentiality, I do not know with certainty many of the details of Superior's failure and, in particular, the roles of the OTS and the FDIC. However, the public information casts suspicion on both the promptness of the OTS's action and the strength of the corrective actions when taken. Nor is a 20 to 45 percent loss rate what I suspect Congress had in mind when it enacted Least Cost Resolution. Indeed, this loss rate promises to be greater than the average loss rate on banks of comparable size in the bad pre-FDICIA days.

It appears that in Superior, as in the earlier costly failures of the First National Bank of Keystone in 1999, and again, the ironically

named BestBank in 1998, a number of red flags were flying high that should have triggered either rapid regulatory response or continuing careful regulatory scrutiny. Although each flag was not flying for each bank, these red flags would include, but not be limited to: Very rapid asset growth. Superior doubled in size in the 3 years between year-end 1996 and 1999, and Keystone grew even more rapidly. Well above market rates offered on insured and/or uninsured counter or brokered deposits. Had the regulators sent their examiners to the dozen banks and thrifts that offered the highest deposit rates in the late 1980's, they would have zeroed in on the worst failures of that period. Rapid withdrawal of uninsured deposits. High ratio of bank repurchase agreements to total funding. This indicates that other banks, which may reasonably be expected to be well informed, are lending only on a collateralized basis; High percentage of brokered deposits; A larger percentage of activities in risky lending. Although legitimate and, at times, highly profitable, subprime lending is generally riskier than prime lending and requires more careful supervision by both the bank's own management and regulators. Very large percentage of assets in not only very risky but also complex derivatives and other nontraditional assets, given the bank size and management capabilities.

None of these flags either by itself or even in combination with others guarantees trouble. But because the cost of spotting them is low, they are worth following up on to see whether the fish really smells.

Based on the public information on recent costly bank failures, I recommend the following proposals for serious consideration: Increased regulatory emphasis on red flags and quicker responses. Establish an interagency SWAT team for valuing complex assets. This would likely be of particular benefits to the OTS and FDIC, who deal primarily with smaller and less complex institutions. Making it an interagency team would reduce turf considerations in calling on it for help. Increase the values of the capital ratios for the tripwires in PCA. This is something that the regulatory agencies can do now and something I have argued for for many years, and that is long overdue. Put the examination fee structures of the OCC and the OTS on the same basis as those of the FDIC and the Federal Reserve. By needing to charge fees for examinations to obtain the operating revenue, there is a tendency for the OCC and the OTS to view their member institutions as clientele, and to be reluctant to take actions that may encourage them to change their charter and primary regulator. Shorten the period for beginning the resolution process after a bank is classified critically undercapitalized to 90 days, with no extension. The evidence is strong that losses to the FDIC increase on average the longer an insolvent or near-insolvent bank is permitted to continue to operate. Increase the ability of the FDIC to participate in on-site examinations by other agencies. And I mention in my longer statement how this may be done. Increase emphasis on market valuations, especially for equity of large banks.

But none of these suggestions would be effective unless the supervisors have not only the ability, but also the will, to comply with the underlying objectives and spirit of Prompt Corrective Action and Least Cost Resolution.

At times, the actions of all four Federal bank regulatory agencies suggest a lack of commitment. It may be desirable, therefore, to encourage additional sensitivity training for regulators, to increase their commitment to these important objectives. Regulators should be judged adversely not by the number of bank failures, but by the cost of the failures.

Thank you.

Chairman SARBANES. Thank you very much, sir.

Ms. Petrou.

STATEMENT OF KAREN SHAW PETROU
MANAGING PARTNER, FEDERAL FINANCIAL ANALYTICS, INC.

Ms. PETROU. Thank you very much, Mr. Chairman.

I would like, since there has been such a well-informed discussion of the specific aspects of the Superior failure and appropriate relation of that to the Keystone, BestBank, Pacific Thrift & Loan, and other recent costly failures, to focus on some specific public policy issues that all of these failures point to.

In the wake of the September 11 attack, we have become all too aware that even hypothetical risks can become suddenly and sadly real. In the same way these bank failures remind us of the importance of vigilant bank supervision.

Many of the actions that Dr. Kaufman and Mr. Ely have suggested were those recommended in a Congressional commission chartered after the wake of the 1980's S&L crisis and, indeed, some of the actions that have been recommended are reinstatements of regulations issued by the bank and thrift regulators in the wake of FIRREA and FDICIA.

For example, there had been a rule triggering regulatory scrutiny for high-growth institutions. That was one of the findings in the 1980's and 1990's, and has been set. Institutions which grow incredibly fast are either run by geniuses or something is up, and the regulators should take extreme care to be sure that it is the former, and not the latter.

Rules to that effect had been promulgated, but in a burst of deregulatory enthusiasm in the 1990's, when we all thought everything would only go up, those rules were repealed. They should be reinstated.

The capital rules are the cornerstone of Prompt Corrective Action. At this times, I would like to shift my focus to them because, as you have said, Mr. Chairman, the role of residuals and the role of recourse in these institutions was critical, not only to their high-risk strategies, but also to their high-cost failures.

It is essential that capital incentives be compatible with risk incentives. The bank regulators talk a lot about incentive-compatible regulation. However, the current risk-based and leverage capital rules run, in my opinion, counter to correct public policy incentives.

Looking ahead at some of the changes being proposed in the new rewrite of the international risk-based capital rules, often called the Basel Accord, the disconnect between regulatory incentive and economic reality for insured depositories will only grow wider. This was clearly the case with the residual rule. It is quite possible under current capital rules that an institution that invests only in zero-risk Treasury securities has to hold higher capital than an in-

stitution like Superior, which holds on its books as capital these very high-risk, complex securitization residuals. That should be fixed. It may well be fixed in the pending rule. It never should have been allowed to last this long.

Congress called on the regulators to act on the recourse issue in 1994, with a specific provision in the Reigle–Neal Act requiring action on recourse. Eight years later, that rule remains a work in progress, hopefully one soon to be completed.

I would like to point out that the cost of poor regulatory capital incentives are not only that risk increases sometimes exponentially with these poor and miscalibrated incentives, but also that the banking system does not work as efficiently as Congress intended.

One of the tragic consequences of the September 11 attack was the destruction of much of the infrastructure that creates asset-backed securities, particularly mortgage-backed securities, private-label ones issued by guarantors other than Government-sponsored enterprises.

Current capital rules place private-label asset-backed securities at a significant capital disincentive to the Government-sponsored ones, even though it has been recognized since the first proposed rewrite of the recourse rules in the early 1990's that there was no rational reason for differentiating high-quality, private-label securities. In the wake of the September 11 attack, with the disruptions to the secondary market, it is much more difficult for the private-label institutions to function. And these capital impediments that they labor under, which are an anachronism, only complicate and prolong the process of economic recovery. Miscalibrated capital rules make economic incentives far less powerful than they otherwise would be.

Another concern about the capital rules is pending proposals to impose a specific capital charge for operational risk. We learned after the September 11 attacks that systems redundancy, contingency planning and insurance are critical to the speedy and, indeed, often remarkable, recovery that occurred after the World Trade Center was destroyed.

A specific capital charge under consideration would, in fact, penalize institutions through their capital requirements for investment in these risk-reducing measures. That again seems counter-intuitive, and it could have the kind of destructive implications that one sees in the Superior, BestBank, and Keystone cases, when the capital incentives are miscalibrated.

I do think it is vital for Congress to take an active interest in the risk-based capital rules. They are adimittedly very technical. But if you will recall, in the late 1980's, when the first round of the Basel Accord was introduced, many analysts, myself and Dr. Kaufman included, argued that those rules, contributed to the credit crunch of the late 1980's and the early 1990's, and slowed economic recovery down. They are technical rules with strong public policy implications.

Thank you very much.

Chairman SARBANES. Well, thank you very much. This panel has been enormously helpful as we try to work through this.

We have been joined by Senator Carper. I am just going to ask a couple of questions and then yield to him. We are very pleased that he is here with us.

First of all, Dr. Kaufman, let me ask you, on these red flags that you indicated, at the moment, are they written anywhere as standards or parameters to guide the actions of the regulators?

Mr. KAUFMAN. On the whole, not. But as Ms. Petrou said, there was in the past a growth flag that was there.

Chairman SARBANES. Is there general agreement amongst the experts that the red flags you set out, is there a consensus that those are appropriate red flags? How do Mr. Ely and Ms. Petrou feel about that?

Mr. ELY. With regard to the red flags, in my testimony, I identified a number. There is a judgment element that comes into play here. And the thing that I have wondered about as I look at these expensive failures, where is the 50 plus senior supervisor with 30 plus years of experience, been in the trenches for years, seen lots of failures, where is that person, man or woman, stepping up to the situation of taking a look at this, looking at the institution, looking at the numbers, and saying, this place stinks. We need to do something about it.

There seems to be a lack of that kind of human factor at work here, where some grey-haired, bald-headed person says, there is something wrong here. All I have to do is take a few minutes looking at it and I know there is something wrong. That is what we mean by the red flags. In a way, it is a matter of taking lots of different factors into consideration and looking at the institution and saying, things just do not look right here. They do not add up. Something is wrong. Go find the problem.

Chairman SARBANES. Well, now, the grey-haired, bald-headed person, may work for you and Dr. Kaufman. But we ought to add into that some woman, striking woman with dark hair as well in this evaluation.

Mr. ELY. My point is that this is what comes from years of experience, of living with these things, these issues, for 20 or 30 years, having been through lots of problems. Again, it is like a doctor who has seen 10,000 patients. When the next one walks in, they can very quickly size up what the situation is.

Chairman SARBANES. Ms. Petrou.

Ms. PETROU. Thank you, Mr. Chairman. My hairdresser appreciates your comment.

[Laughter.]

In fact, FDICIA, which was a product of compromises and contention that you, I know, remember very well, is a remarkably robust statute. And, in addition to the Prompt Corrective Action provisions in Section 131, it also has an array of operational and managerial safeguards that Dr. Kaufman referenced, which you can find in Section 132. Those are the red flags.

I agree in general with the regulators' determination not to issue those as binding rules because, as Mr. Ely says, judgment is an important factor. It is also true that some institutions manage risk better than others. In fact, some institutions are quite successful, profitable, well-capitalized, subprime securitizers. But the agencies need to look at those red flags.

They are specific in the statute that tell the industry what the agencies will be looking form and they are issued in a way that permits them to take rapid and binding supervisory action.

Chairman SARBANES. Dr. Kaufman, do you want to add anything?

Mr. KAUFMAN. I do not think so. I agree with what was just said.

Chairman SARBANES. Ms. Petrou, in your testimony, you recommended—I think I am quoting you correctly here, "The FDIC should have expedited authority to review troubled institutions, but no greater authority should be granted to review healthy banks."

Ms. PETROU. That is correct.

Chairman SARBANES. And of course, regulators currently identify the healthiest banks by giving them the top supervisory CAMEL rating of "1". Now in December 1998, Superior was a CAMEL "1" rated institution. If the FDIC had no greater authority to examine a "1" rated institution, it might well not have been able to move in on Superior. I mean, we had the other problems. But that standard may not work, might it not, at least in this instance? Of course, we had these gross over-statements of value and so forth, which collapsed finally when they dealt with the accountants. But what is your response to that concern?

Ms. PETROU. I do not think that the FDIC should have unilateral authority, to be seeking, to enter and examine healthy, CAMELS "1" institutions; which is what I had understood the FDIC to be seeking, at least in some earlier statements.

The reason for that is because I believe there is a tremendous potential for misallocation of supervisory resources. As Mr. Ely has said, for example, the FDIC has a major responsibility to be the deposit insurer and to ensure that the incentives of deposit insurance work to support supervisory ones. The current, and I would say significant problems in the risk-based premium matrix require urgent FDIC attention.

Should the FDIC seek the authority, of a back-up enforcer, and request such from the primary supervisor, I absolutely agree as Director Seidman has said, that should be granted. However, I do not think that the FDIC should have unilateral authority on its own to supervise healthy institutions.

Mr. ELY. Mr. Chairman, if I could add to that.

There is not really a lot of concern when institutions are "1" and "2" rated. Where the concern really starts to grow is when you drop down to a "3" rated situation and specifically, where the chartering agency may rate the institution as a "2", but the FDIC, just looking at call report data and reviewing the exam reports that is off the site, comes up with a CAMEL rating of "3" or lower. Then that might be a situation specifically where the FDIC should be able to go to the chartering agency and say, listen, there is a difference here in CAMEL rating that is significant enough that we are going to go in, we need to go in with you on the next exam, unless you have a real powerful reason as to why we should not. In other words, drawing again the distinction between the "2" and "3", that is perhaps the most important distinction that needs to be drawn.

Chairman SARBANES. How do we square that comment with the fact that Superior, in December 1998, had a "1" rating? And in fact, in 1999, had a "2" rating.

Ms. PETROU. Mr. Chairman, if the capital incentives were better drawn, they never would have had a CAMELS "1" rating because they would not have been able to count residuals as capital.

Chairman SARBANES. That is a good answer.

Ms. PETROU. The CAMEL system is very heavily dependent on the first C—it is supposed to stand for Capital Assets Management Earnings Liquidity and Sensitivity. Each one of those letters has a meaning as to what the supervisors are to look for. But in fact, it is very heavily capitaldependent and the capital incentives are misplaced.

Mr. ELY. I would agree with Ms. Petrou. The other problem with capital is that it is a lagging measure of a bank's risk because, in effect, it does not reflect asset write-downs that have not yet been taken. Also, if I remember correctly, in 1999, the OTS dropped it from a "1" to a "2", but the FDIC dropped it to a "3". And there was a point in time there where you again had that "2"/"3" split. And that is the kind of situation I have in mind where the FDIC should basically be able to, if not go in on its own motion, at least be able to insist on accompanying the examiners from the other agency in the next exam.

Chairman SARBANES. Dr. Kaufman, if you don't want to add anything, then I am going to yield to Senator Carper.

Mr. KAUFMAN. No, that is fine.

Chairman SARBANES. Okay. Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

I remember when Bert Ely had a full head of black hair.

Mr. ELY. That was a long time ago.

Senator CARPER. And Karen Petrou was Karen Shaw. It is just great to see each of you again. I had the pleasure when I was on the House Banking Committee to sit in a hearing like this, to be educated, and to walk out of there feeling a whole lot better about what we were going to do as a Committee because we heard from each of them. Thank you for being with us today. Thank you for excellent, excellent testimony.

I want to just ask a couple of questions. Let me just start off by saying, there must be some angst in this country, some banks that are in the same kind of business as Superior, making their money pretty much in the same way, that are not on the same road to ruin. I would just ask you, what might distinguish the way those banks are being operated and the way that Superior was run into the ground?

Mr. ELY. If I could address that because I have spent some time looking at Superior. Superior was really almost unique in terms of its particular business plan. It really was an outlier in terms of residuals on the balance sheet. There are, however, some other institutions out there that are outliers in different ways that I also have concerns about.

But I am not aware of another institution operating today that closely resembles Superior. Keystone was another one that had a lot of the characteristics of Superior, but, of course, that failed a couple of years ago.

Ms. PETROU. Senator Carper.

Senator CARPER. Karen.

Ms. PETROU. I would say that thing that distinguishes Superior is it was closely held amongst two principal owners in a highly complex structure that integrated the institution with the real estate development businesses of the two principal owners. That significantly distinguishes Superior from institutions that are broadly traded in the public market, covered by many investment analysts and subject to market discipline.

In my written testimony, I strongly recommend that management and corporate structure be among the red flags that the supervisors rely upon. And it may well be that such closely held institutions not be given CAMEL "1" ratings strictly because they do run a much higher degree of supervisory risk.

Senator CARPER. Dr. Kaufman.

Mr. KAUFMAN. Something that I have emphasized in my testimony, that we really should not be that worried about the bank failures, per se. Poorly managed banks should be permitted to fail. What is important is that they fail with no cost to the FDIC, that we should not try to keep all banks alive, that banks should be given the opportunity, so to speak, to fail. That is important to drive the inefficient and the unlucky banks out.

What is important and where the FDIC, particularly the OTS, failed in this case, the Keystone case, and the BestBank case, was that the banks did not only fail, but also they failed with very large losses. And that should not happen.

Mr. ELY. Senator Carper, if I could just endorse something that Karen said. Not only was Superior closely held, but also the same was true of Keystone and BestBank, all closely held institutions.

And while we had a number of publicly owned, broadly owned banks and thrifts that failed in the 1980's, including some very large institutions, I do think that market discipline that comes from broad common stock ownership, has improved in the 1990's.

Again, Karen makes a very good point that kind of a negative for a bank is if there is a lack of public ownership and the following by bank stock analysts, and also the need for the company to file with the SEC. The SEC filings and the SEC review of those filings also introduces an important element of oversight that is lacking in these closely held institutions. And again, it also addresses George's point. If you have market discipline, the stock price will be dropping sooner, and that is going to force action—it will be a market-driven action—long before they reach the depth of insolvency that we have seen in these very expensive failures.

Senator CARPER. Each of you were good to give us a laundry list of recommendations that we might pursue. What I want to ask you to do is to establish some sense of priority in terms of the importance of those recommendations. I would just ask you to reflect back on those recommendations and to say, Mr. Ely, if we were only to, as a Committee, as the legislative branch, do two of them, which two should we do first?

Mr. ELY. I think the most important one is to hold senior regulators personally responsible for the expensive failures. Frankly, if there were a few people fired over these failures, that that might have a tremendous disciplining effect on the agencies. And that is perhaps the single most important one that immediately comes to

mind. I think the others are important. But there still has to be this sense of personal accountability.

The banking regulators have a fiduciary obligation to the banking industry. Why is that? It is for the point that George made, that Congress very properly has made deposit insurance and privately financed system because the banks were on the hook for the losses. And my sense is that within the regulatory establishment, there is not that sense of fiduciary responsibility to the banks because, in a sense, we have a moral hazard situation. If the regulators err, it is going to be the banks who are going to pay through higher premiums. And this goes to the point that the Chairman made in the first panel. What is going to be the impact of additional losses on the reinstitution of premiums? So, I would say that is, the single most important recommendation.

Senator CARPER. Thank you.

Dr. Kaufman.

Mr. KAUFMAN. I guess I would say to move sooner rather than later. But I do not think that we could rank, or that we should rank, these red flags or these recommendations because every bank is different. And you do not want to lock the regulators into a structure which may work for Bank A and we miss in Bank B. If we have a large number of flags, we have the Prompt Corrective Action which we could strengthen, particularly in the way that we measure capital.

Congress, indeed, in FDICIA urged the regulators to move more toward market value accounting. The regulators have not done so. But I would not lock in the regulators and just a limited number of signals because we have 10,000 banks and thrift institutions and they vary all over the ballpark.

Senator CARPER. Ms. Petrou.

Ms. PETROU. I would emphasize the important role of capital. The Chairman has pointed to the delay in issuing the residual rule and the recourse rule as significant factors, not only in Superior, but also in Keystone, BestBank, and Pacific Thrift & Loan.

This problem could get worse, not better, because of some proposed changes to the capital rules. And I urge Congress to take an active role in reviewing these changes so that they do not have an adverse macroeconomic or systemic risk impact. The rules do look awful, and they are 700 pages. They are highly technical and I would not wish them on you. But I do think that they are the major drivers of bank decisionmaking because, ultimately, profitability is determined by return on equity. Therefore, how much and what type of equity the regulators demand determine the economic incentives under which bank managers operate.

Mr. ELY. Senator Carper, I wonder if I could add to that on capital and on the Basel capital rules. The Basel 1, the ones adopted in the late 1980's, as well as Basel 2, the rules that are under consideration now and may be under consideration for many years to come, both have a very serious failing. And that is that there is no guidance in there with regard to loss provisioning, the reserving for losses, reserving for the decline in asset value.

A measure of capital is only as good as the values that are associated with assets. And if assets are not written down properly to their value, then you are going to have overstated capital. And that

is what happened in Superior in spades. Not only were its assets overvalued, but also they were overvalued for many years.

What we see in the Basel rules is, while we talk about capital, there is no explicit addressing of the issue of loss reserving and if you do not have that, you do not have good capital rules.

Senator CARPER. Mr. Chairman, this is an excellent panel, and I just want to thank you for bringing them together.

Again, to each of you, thank you for joining us today and sharing your counsel with us.

Chairman SARBANES. Yes, we are deeply appreciative for your contribution. And if it is not too much of an imposition, I expect we will call on you again because we really need the benefit of this outside perspective that you bring.

We are now following closely these regulations which will be an important step forward, assuming they do the right thing. And then we will have to move from there in other ways to tighten and strengthen the system. Thank you very much for your contribution.

The hearing stands adjourned.

Senator CARPER. Thank you.

Mr. ELY. Thank you.

Mr. KAUFMAN. Thank you.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material submitted for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Chairman Sarbanes, thank you for holding today's hearing into the failure of Superior Bank of Hinsdale, Illinois. Preparing for today's hearing was especially poignant. As you no doubt remember, Mr. Chairman, you and I sat together on this dais the morning of September 11, before the magnitude of the day's events had become clear. While the terrorists distracted us temporarily from the business at hand, we gather today with renewed determination to keep America's economy strong.

When Superior Bank failed on July 27 of this year, there was a lot of finger-pointing among the parties involved. In the past month, we have learned an important lesson about how much we can achieve when we pull together toward a common goal. Today, it is my hope that we can examine the problems that caused the failure of Superior Bank, identify what systemic weaknesses we need to address, and work together to reassure the American people that we have the strongest banking system in the world.

In the last month, we have gained a renewed appreciation for the strength of America's financial institutions, which have withstood the futile attempts against them. At the same time, we in Congress, on a bipartisan basis, have identified some areas that could be strengthened still further. Recently, by a 21–0 vote, the Senate Banking Committee passed a significant antimoney laundering package, which provides our law enforcement personnel essential weapons in the war on terrorism.

I congratulate you, Mr. Chairman, for pulling our diverse Committee together behind a package that helps our country wage war on terrorism. I urge my colleagues in the House of Representatives to pass this critical legislation so President Bush can sign it into law. The Senate acted swiftly to arm our law enforcement personnel against terrorists, and it is now the House's turn to act.

Today, we must take a hard look at many different issues that keep our financial institutions strong, including Prompt Corrective Action, methods of valuation, the role of accounting auditors, and interagency cooperation, to name a few. These measures, which help to comprise our rigorous regulation of financial institutions, are absolutely critical in keeping Americans confident about our financial marketplace. But while today's hearing is likely to focus on these more technical issues that may be able to prevent bank failures, we must not forget that when banks do fail, Federal deposit insurance plays an absolutely critical role in maintaining consumer confidence in the banking system.

Federal deposit insurance is one of the cornerstones of our financial system, and it is worth pausing to note that the failure of Superior Bank appears to have caused little, if any, public panic about the health of our banking system. This is the goal of Federal deposit insurance. And it is no small feat. According to FDIC policy for a conservatorship situation, the agency typically closes a failed institution on a Friday after the close of business, with the goal of reopening on Monday in a way where the customers would be hard-pressed to identify any differences in the bank's operations.

Indeed, our deposit insurance system is premised on the assumption that banks and thrifts will, on occasion, fail, despite the best efforts of regulators. We should remember that the regulatory agencies deserve significant credit for their hard work in keeping our banking system healthy. Their task is especially challenging where there is fraud by the institution, or serious error by a national auditor.

This failure is especially notable, as were the failures of First National Bank of Keystone, West Virginia, and BestBank of Boulder, Colorado, because of the magnitude of the failure proportional to the size of the institution. Preliminary loss estimates for Superior Bank range from $500 million to $1 billion, with a loss rate of anywhere from 20 to 45 percent. The data is not yet final, but early estimates show that the failure could cause a significant drop in the SAIF ratio, which, as I have said in the past, should help to focus Congress and industry alike on reforms to our deposit insurance system. The current deposit insurance system is dangerously procyclical, and the time to make changes is now.

Mr. Chairman, I am particularly troubled by the losses of Superior's uninsured depositors. While the numbers have not been confirmed, the FDIC estimates that uninsured depositors held upward of $64 million in Superior on July 27. According to one report, 816 depositors held $66.4 million in uninsured deposits on the day Superior was shut down.

Even worse, to my mind, is the fact that Superior's uninsured deposits increased by $9.6 million in the second quarter of this year, when the regulators knew that the bank was in trouble.

Who were these uninsured depositors? Clearly, some were sophisticated investors who followed call report data and pulled out of Superior when the situation looked

precarious for the thrift. Although in this case, we have reports that Superior misreported its Thrift Financial Reports, which reduces the possibility of even sophisticated depositor discipline.

As to the rest of the uninsured depositors, press reports are informative. It was reported that a former parcel carrier who was injured on the job had deposited a hard-fought settlement of $145,000 in Superior on July 26—the day before the Hinsdale thrift collapsed. Another woman deposited $120,000 in proceeds from her recently deceased mother's home just days before Superior was closed by the regulators. And it is hard to believe that Superior is unique in serving uninsured depositors, many of whom rely on their bank's safety to protect their retirement savings.

As I have said before, Congress has a particular responsibility to think about the appropriate level of Federal insurance of retirement funds. We provide tax incentives for people to save for their retirement, and in fact we recently increased those savings incentives. People who set aside relatively modest amounts every year for retirement can easily amass more than $100,000, and many of these savers are working families who scrimp and save to make sure that they are self-sufficient in their old age, and that they do not become a drain on the next generation. It seems to me the next step for Congress is to make sure that our working families have the option of a safe investment for those funds.

According to the FDIC, approximately $60 billion of retirement funds are sitting uninsured in depository institutions, and that a higher deposit insurance limit would dramatically reduce the risk to these prudent savers. I plan to hold a hearing later this month in the Financial Institutions Subcommittee to consult with experts in the field of retirement savings about how we in Congress can act to protect the hard-earned savings of responsible, working Americans. While we on this Committee must do everything we can to prevent banks from failing, we must also take steps to protect investors should an institution fail, despite our best efforts.

I thank the witnesses for their extensive and thoughtful written testimony, and I once again thank you, Mr. Chairman, for rescheduling this hearing.

PREPARED STATEMENT OF ELLEN SEIDMAN

DIRECTOR, OFFICE OF THRIFT SUPERVISION, U.S. DEPARTMENT OF THE TREASURY

OCTOBER 16, 2001

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 parties involved are trying to get to the bottom of what went wrong at Superior Bank, 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 the 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. The 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.[1] 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. 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.[2]

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 the OTS made the right calls with respect to Superior Bank.

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 CFR 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, it would have been—in late 1999 and early

[1] While this is high, it is not the highest percentage for recent failures. Two non-OTS institutions had higher percentage loss estimates. Pacific Thrift & 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.

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

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 the OTS and the 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 Bank. Were there occasional disagreements in judgment between the 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 the 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.

The 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 the 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 wholly owned 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 5 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 com-

pany that operates as a full service mortgage banker originating or purchasing, on a wholesale basis, mortgage loans secured by first and second liens on 1 to 4 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's exam report off-site for the August 1994, September 1995, October 1996, and December 1997 examinations. During this period, FDIC did not dispute OTS's 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 nonprime 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 (FBA's") issued interagency guidance on asset securitizations in December 1999. 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"[3] 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 CFR 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 1 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 originated loans to its holding company. This stopped the growth of residuals at the institution. The 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 CFR § 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 timeframe. 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's 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 on 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 con-

[3] Superior was adequately capitalized on a risk basis. Tier 1 equity capital exceeded 12 percent, in the well-capitalized range.

trary, 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 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. The 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 2 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 3 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 en-

tity 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, the 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 creditworthiness 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, overdependence 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 reapportioning the cash flows (interest and prin-

cipal payments) from the loan pool to the security holders in the order of their seniority. In essence, the cash flows 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 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 ad-

vances. 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 BestBank failure. The issuer benefits by continuing to recognize inflated overcollateralization 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 amounts booked, several regulatory concerns have arisen. First, examinations have repeatedly encountered inconsistency and over-optimism in 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 enough to overcome disincentives to prepayment, as they have recently, or as borrowers' credit ratings improve. This second factor (credit-induced prepayment) is absent 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 (for example, 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 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, the 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 FBA's 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, responding to increased use of securitizations by institutions, the Federal banking agencies (FBA's) 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 FBA's 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 FBA's published a notice of proposed rulemaking on residual interests in asset securitizations or other transfers of financial assets (Residuals Proposal).[4] 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 FBA's further proposed a deduction from Tier 1 capital of the total amount of residual interests held by an institution in excess of

[4] See 65 Fed. Reg. 57993.

25 percent of Tier 1 capital. This, in effect, creates a concentration limit because of the severity of the capital requirement.

The FBA's 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 Bank, the 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 FBA's 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.

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 FBA's. These include problems with GAAP as it is applied to the regulatory reporting requirements of the FBA's, 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 FBA's 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 generally accepted 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,[5] 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,[6] the transaction will produce the following results:

The transaction produces a "cash loss" of $20, computed as follows:

[5] 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.

[6] The total value exceeds the face amount of the loans because it includes the discounted expected future cash flows (that is, interest payments and late fees).

Cash proceeds	$980
Cost of loans	(1,000)
Cash gain (loss) on sale of loans	(20)

Under SFAS No. 140, however, a "gain-on-sale" of $30 is reported,[7] computed as follows (using a simplified method):

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

The "gain-on-sale" of $30 can be reconciled as follows:

Cash gain (loss) on sale of loans	$(20)
Retained residual interest	50
Gain-on-sale	30

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 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.[8] 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 FBA's 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 the regulatory burden. Most RAP/GAAP differences that existed in the 1980's and the early 1990's were eliminated for this very reason. Nevertheless, in light of the very substantial concerns we have had with the valuation of residuals and their volatility, as discussed above, the FBA's 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 FBA's regarding the potential impact of the change or revision.

[7] 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.

[8] 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.

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, for example, 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 FBA's 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. The 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 form 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 insti-

tution'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 TFR's) 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[9]

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 FBA's the tools to minimize the potential cost to the deposit insurance funds of troubled institutions and ensure that the regulators not only could, but also 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.

At the same time PCA was enacted, Congress added a new Section 39 to the FDIA to address the full panoply of noncapital related safety and soundness related management and operational standards. That new authority authorized the FBA's 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 shrank by about 15 percent in its final 6 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

[9] See also the discussion of resolution of accounting disputes, above.

issued 32 notices under Part 570, half of them related to Y2K. Other than Superior and Oceanmark,[10] 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 institution's capital position over time. PCA contains provisions allowing for downgrades in PCA categories based upon noncapital 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 noncapital 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 FBA's 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 helpful.

VI. Interagency Coordination Issues

An issue that has spawned 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 Superior's failure.

In particular, I believe it is unlikely that the addition of one FDIC examiner to OTS's 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 FBA's 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 prefailure shrinkage, where not.

[10] 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.

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 nontroubled 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 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 10 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 4 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 2 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 will not really understand what is at issue. At OTS, our small size and flat structure helps me break this down, but we are 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 would not only do a better job, we would also 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 is 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.

PREPARED STATEMENT OF JOHN REICH

DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION

OCTOBER 16, 2001

Mr. Chairman, Senator Gramm, and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation regarding the failure of Superior Bank FSB, Hinsdale, Illinois (Superior). In my testimony today, I will briefly summarize the crucial issues, which make the failure of Superior of special interest to the regulators, the Congress and the public. I will provide a brief chronology of the FDIC's role in the events leading up to the failure of Superior followed by a description of our actions in resolving this troubled thrift. Finally, I will turn to a discussion of the lessons learned.

Introduction

The primary reason for Superior's failure was the decision of its board and management to book high levels of retained interests related to the securitization of subprime assets. The retained interests were deeply subordinated, at a first loss position, to more senior claims on the more than $4 billion in subprime loans that Superior Bank sold to investors. Over the course of several years, Superior's retained interests represented an increasing multiple of its Tier 1 capital.

Volatility of Retained Interests

Since 1998, failures of institutions with risk characteristics similar to those of Superior have cost the FDIC insurance funds more than $1 billion. The failure of Superior Bank again highlights the inherent volatility of retained interests.[1] Retained interests, sometimes referred to as "residuals," represent an accounting recognition of immediate gains on the sale of assets in the course of securitization activities. These interests pose significant valuation and liquidity concerns, particularly when related to higher-risk subprime or high loan-to-value loans. A complex, assumption-

[1] Retained interests are balance sheet assets representing the right to a specified portion of the remaining cash flows from a securitization after paying bondholder obligations, covering credit losses, and paying servicing and trust-related fees.

driven valuation process makes the value of the retained interest very volatile and subject to much interpretation.

Limits of Prompt Corrective Action

The failure of Superior also illustrates the limits of Prompt Corrective Action (PCA)—tools given to the regulators in 1991 to assist in the supervision of insured institutions and to assist in avoiding high costs to the insurance funds when institutions do fail. Although it has yet to be tested during a prolonged economic downturn, so far PCA has been successful and has worked in a high percentage of cases involving problem institutions. In fact, most troubled institutions turn around during the PCA supervisory process. However, the corrective actions under PCA will not necessarily stem the losses in situations where unrecognized losses are already embedded in the assets. This is especially true in situations such as the failure of Keystone National Bank, which involved fraud, and Superior Bank, which involved a dramatic restatement of the complex, assumption-driven values related to retained interests.

Failures caused by fraudulent activity by bank managers or directors also pose a challenge to regulators and the implementation of PCA. From a supervisory standpoint, fraudulent activity is by its nature harder to detect than is unsafe or unwise conduct. Because fraud is both purposeful and harder to detect, it can—and frequently does—significantly raise the cost of a bank failure. The same internal weaknesses that lead to credit and other operating losses have provided opportunities for dishonest and illegal activities.

Finally, the failure of Superior highlights the role of the institution's accountants when their opinions are at odds with the regulators. Going forward, this is a serious public policy issue that must be addressed.

As discussed in detail later in this testimony, the FDIC believes the banking agencies need to continue work toward ensuring that adequate risk-based capital is held against retained interest assets, as well as implementing limits on the degree to which retained interests can be recognized for regulatory capital purposes.

FDIC's Role in the Events Leading to the Failure of Superior Bank

The Pritzker and Dworman families purchased Superior Bank in 1988 in a Federal Savings & Loan Insurance Corporation (FSLIC) assisted transaction. At the time, the thrift was troubled and the investors injected $42.5 million into Superior through a holding company, Coast-to-Coast Financial Corporation (CCFC). CCFC, in turn, owned Superior FSB through a shell holding company, Superior Holdings, Inc. (SHI), which was formed in 1998 and became a thrift holding company in 1999. CCFC itself was owned by a multitiered and complex set of companies/trusts that is controlled by the Pritzkers and Dwormans.

During the late 1980's and early 1990's, the thrift operated under an assistance agreement with the FSLIC.[2] The FDIC examined the troubled thrift several times during this period, usually concurrently with the Office of Thrift Supervision (OTS)—Superior's primary Federal regulator. Superior's supervisory rating was eventually upgraded to a CAMEL rating of composite "2" in 1993 when the institution's condition stabilized.[3] From 1993 to 1996, the thrift was rated a composite "2" by the OTS. In October 1997, the OTS assigned a composite "1" rating. During this period of time, based on the apparently satisfactory condition of the thrift, the FDIC's review of the thrift's financial condition was primarily limited to off-site monitoring of publicly available quarterly statements of income and condition filed with Federal regulators, OTS examination reports, and other available information.

The FDIC's interest as insurer was heightened in December 1998 when we conducted an off-site review of Superior, based on September 30, 1998 financial information. 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. Based on these concerns, the FDIC sent a written request that an FDIC examiner participate in the January 1999 OTS examination. OTS

[2] This 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 the 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 are currently pending.)

[3] CAMEL is an acronym for component ratings assigned in a bank examination: Capital, Asset Quality, Management, Earnings, and Liquidity. In 1997, an additional component, "S" for Sensitivity to market risk, was added. A composite CAMELS rating combines these component ratings, again with 1 being the best rating.

orally denied this request but did share work papers and met with the FDIC at the end of the 1999 examination to discuss the bank's condition.

The FDIC's review of the OTS's January 1999 examination and additional off-site monitoring generated significant concerns about the institution's risk profile, particularly with regard to unusual regulatory reporting, and the high, and growing, concentration in retained interests and other high-risk assets. As a result of our concerns, the FDIC officially downgraded the thrift to a composite "3" in May 1999, triggering deposit insurance payments under the risk related premium system. (OTS had downgraded the institution to a composite "2" after the 1999 exam.)

In September 1999, the OTS concurred with a formal FDIC request to participate in the January 2000 examination. Findings from this examination revealed many weaknesses, including extremely high concentrations of high-risk assets, inadequate management and controls, inaccurate reporting, and lack of documentation/support for retained interest valuations. The OTS and FDIC both assigned composite "4" ratings for the thrift in May 2000.

As the primary Federal regulator for this institution, the OTS issued a safety and soundness plan as a corrective action that, among other things, required the thrift to get an independent valuation of the retained interests, which was ultimately performed by Ernst & Young (E&Y). FDIC and OTS examiners extensively reviewed the valuation and discussed it with thrift management and E&Y. In early August 2000, the FDIC noted that estimated future cash flows were not discounted to present value for some retained interests, which had the potential of significantly overstating the value of the retained interests. In late August 2000, the FDIC and OTS raised the issue with E&Y, who agreed to revisit the issue as part of their upcoming audit of Superior's June 2000 fiscal year-end financial statements.

FDIC then participated in an OTS visit to Superior in October 2000 to review this issue, among other things. From this point until mid-December, in various correspondence, the local E&Y office attempted to support its position that the future estimated cash flows should not be discounted. OTS and FDIC objected, and in late December, the OTS directed the thrift to raise the issue to E&Y's national office.

In mid-January 2001, E&Y's national partner agreed with the regulators, and the thrift began the process of revaluing the assets. Examiner estimates showed that the revaluation would result in significant writedowns and, in mid-February the OTS issued a Prompt Corrective Action (PCA) Significantly Undercapitalized notice to the thrift and Cease and Desist Orders to several of the holding companies.

On March 2, 2001, the thrift amended its financial statements, taking a $270 million (gross) writedown on its books, reducing the capital ratio to 2.08 percent and book capital from approximately $250 million to $43 million. At this point, the FDIC downgraded the thrift to a composite "5". An OTS examination, with FDIC participation, began on March 19, 2001.

The thrift submitted its first PCA capital plan in mid-March, and a number of discussions were held between the regulators and with the thrift's owners and management to address inadequacies in the plan. Various revisions were made to the plan over the next 2 months, with a modified plan received on May 18, 2001. During this time period FDIC raised a number of concerns about the plan with OTS both orally and in writing.

The proposals were very complex, but essentially provided for the sale of the thrift's retained interest portfolio to an entity to be owned, but not controlled by the Pritzkers (known as "Newco"). On May 24, the OTS approved the final capitalization plan. The FDIC had made a number of comments about the plan but ultimately did not object. At the time of OTS's approval, we believed that the plan, which called for a $270 million cash infusion, increased the chances for the thrift to become viable. It appeared that the bank would have an opportunity to begin to stabilize if the capital plan was implemented as presented. Also, all parties understood that cost cutting and shrinkage, and perhaps additional capital and strategic alliances would be necessary in the long run to ensure the thrift's viability.

During the next 2 months, the FDIC and the OTS remained on site at Superior while the thrift's owners and management began implementing the plan. Among other things, the owners began to negotiate the loan agreement called for by the plan, develop required accounting and legal opinions, shed businesses, and cut costs. However, in mid- to late-July, the Pritzker family began indicating its reluctance to implement the plan as their and Dworman's proposed capital contributions appeared to be at greater risk. At that time, there had been marked deterioration in the loans underlying the retained interests, according to thrift representation. Also, the proposed lender had prepared a projection that showed cash flows could be less than those projected by the thrift's management. Numerous meetings were held with the OTS, thrift management, and the Pritzkers and Dwormans to discuss the issue.

Ultimately, the Pritzkers and Dwormans failed to implement the capital plan. On July 25, 2001, the FDIC Board met to consider Superior and met again on July 27, 2001, when the OTS closed the thrift and appointed the FDIC as receiver.

Resolution of the Superior Bank Failure

When the FDIC took responsibility for Superior, the first priority was to provide virtually uninterrupted service for insured depositors. The FDIC transferred all the assets and insured deposits to New Superior, a newly chartered, full-service mutual savings bank under FDIC conservatorship. All insured depositors and customers automatically became customers of New Superior and depositors continued to have access to their funds by writing checks, using debit cards, going to New Superior's Internet site, and using automated teller machines.

Deposits—Insured and Uninsured

At the time of closing, Superior had approximately $1.7 billion in over 91,000 deposit accounts. Of this, approximately 94 percent of the accounts totaling $1.4 billion were initially determined to be fully insured and transferred to New Superior. Depositors had full access to these funds when the branches reopened Monday morning. The remaining 6 percent of the accounts, totaling approximately $280 million, were considered potentially uninsured funds that required further FDIC review. To address the concerns of potential uninsured depositors and other customers, the FDIC immediately set up toll-free call centers, which handled over 8,700 customer inquiries during the closing weekend and over 48,000 customer inquiries through August 31. For those callers who had questions about deposit insurance coverage, appointments were scheduled with FDIC staff members. Through August 31, the FDIC has determined that an additional $165 million of the $280 million in deposits is insured and these funds have been released to depositors. Three percent of the $1.7 billion in total deposits have been determined to be uninsured—a total of $49 million. The FDIC is still gathering information from depositors to review insurance coverage for an additional $68 million in deposits to determine if those deposits may be insured. The FDIC continues to work with depositors to resolve the remaining claims and ensure that insured depositors are protected.

Resolution Strategy and Management

The FDIC's strong preference in resolving a bank failure is to market the bank prior to the FDIC's appointment as receiver. This type of transaction allows us to minimize disruption to the failed bank's insured depositors and customers, while minimizing the cost of failure to the deposit insurance funds. When Superior failed, however, the FDIC had not had an opportunity to effectively market the bank or its assets. After reviewing the alternatives, the FDIC Board of Directors determined that a conservatorship would be the least-cost alternative to the Savings Association Insurance Fund (SAIF), while maintaining banking services in the communities served by Superior. Unlike liquidation or other alternatives, the conservatorship allows the FDIC to market New Superior as a going concern and to attempt to sustain the ongoing value of the thrift's business. The FDIC Board believed this was crucial to maximizing the sale price for the deposit franchise, the loan origination network, the loan servicing operation, and the residual interests and related servicing.

An important component of this strategy is effective management of New Superior. The FDIC has been able to obtain the services of an experienced banker, John D. Broderick, to serve as New Superior's Chief Executive Officer and President. The FDIC also created a five-person Board of Directors to oversee New Superior's operations during the conservatorship. The primary goal of Mr. Broderick and New Superior's Board is to prepare the institution for a return to the private sector in the near future.

The effectiveness of the conservatorship strategy requires that New Superior continue to be a full service bank. Accordingly, New Superior is continuing to accept deposits and make loans. To support operations, the FDIC has made available a $1.5 billion line of credit. Through August 31, New Superior had drawn down $644 million to maintain an appropriate liquidity cushion and finance operations. We anticipate substantial repayments to the line of credit as operations continue.

Alliance Funding, a division of Superior headquartered in Orangeburg, New York, continues to direct New Superior's consumer finance and mortgage banking operations. The FDIC has retained HanoverTrade.com, a subsidiary of Hanover Capital Mortgage Holdings, as a financial advisor to assist in the valuation and marketing of Alliance-related assets.

The FDIC is working with the staff of New Superior to return the institution to private ownership as soon as possible. The FDIC plans to start contacting potential bidders this month and expects to begin returning the deposits and assets to the

private sector in October with completion by year-end. We will have a better estimate of the cost to the SAIF upon the final resolution of the conservatorship.

Lessons for Bank Management and Bank Regulators

The Offices of the Inspector General of the Department of Treasury and the FDIC and the General Accounting Office are all conducting reviews, and may have recommendations for the FDIC and the OTS. However, certain lessons can already be drawn from the Superior failure and the failure of several other institutions in the past few years.

Subprime Lending and Securitization Remain a Concern

Concentrations in retained interests related to subprime assets figured prominently in at least two bank failures prior to the Superior failure, Keystone National Bank and Pacific Thrift and Loan (PTL). The FDIC has addressed these activities in various forms.

We have developed risk-focused examination procedures for evaluating subprime lending programs and securitization activities. The FDIC also closely monitors, on a quarterly basis, all insured institutions having 25 percent or more of Tier 1 Capital invested in subprime loans, high loan-to-value mortgages, and/or retained interests in securitizations. Effective on June 30, 2001, the FDIC, OCC, and Federal Reserve implemented a new Call Report schedule that significantly increases our ability to monitor retained interests on an off-site basis.

Subprime Lending

Since 1997, the FDIC and the other Federal banking regulators have been warning the industry about the increased risks in subprime lending through various formal communications and during on-site examinations. Subprime lending can meet the credit needs of a broad spectrum of borrowers in a safe and sound manner if: (1) risks are effectively managed through proper underwriting standards and attention to servicing; (2) loans are priced on the basis of risk; (3) allowances for loan losses cover the potential credit losses in the portfolios; and (4) capital levels reflect the additional risks inherent in this activity.

However, in some cases, these safeguards are not always maintained. The FDIC estimates that approximately 140 insured institutions have significant exposures in the subprime lending business. These subprime lenders represent just over 1 percent of all insured institutions, yet they account for nearly 20 percent of all problem institutions—those with CAMELS ratings of "4" or "5". Ninety-five percent of all insured institutions are rated CAMELS "1" or "2," while only 70 percent of the identified subprime lenders are so rated.

While not necessarily the proximate cause of the failure, 8 of the 22 banks that have failed since 1997 have had significant subprime lending portfolios. Further, since most subprime lenders in the bank and thrift industry have not been tested in a prolonged economic downturn, it is realistic to expect additional problems for institutions with concentrations of subprime loans should the economic conditions deteriorate further.

Securitization of Subprime Loans

A common theme emerging from our supervision of subprime lending is the uncertainty regarding the valuation and accounting for retained interests. In a securitization, the subprime lender sells packages of loans to another party or institution, but often retains as an asset the right to receive a portion of the cash flows expected from the loans. The expected value of these cash flows is generally referred to as the retained interest. A number of assumptions are involved in estimating the value of these retained interests, including default rates, loss severity factors, prepayment rates, and discount rates. Varying legal structures of securitizations and the number of factors that underlie the various assumptions further complicates the process.[4]

Under Generally Accepted Accounting Principles (GAAP), the fair value of these expected future cash flows are recorded on balance sheets as assets in the form of interest-only strips receivable, spread accounts, or other rights, sometimes referred to as retained interests. The best evidence of fair value is a quoted market price in an active market. But in the case of retained interests where there is no market price, value must be estimated based on the assumptions mentioned above. These assumptions need to be regularly analyzed and adjusted for current conditions.

Even when initial internal valuations are reasonable, unforeseen market events that affect default, payment, and discount rates can dramatically change the fair value of the asset. These complications sometimes lead to differences of opinion be-

[4] For example, interest rates, economic conditions, loan terms, and loan underwriting, among other things, drive prepayment rates.

tween examiners and banks and their accountants regarding the accounting and valuation of these assets. In the Keystone, Pacific Thrift & Loan, and Superior cases, the accountants, all nationally recognized firms, did not initially agree with examiners, resulting in protracted valuation and examination processes.

The banking agencies issued supervisory guidance concerning retained interests to banks on December 13, 1999. That guidance requires bank management, under the direction of its board of directors, to develop and implement policies that limit the type and amount of retained interests that may be booked as an asset and count toward equity capital. This interagency guidance also states that any securitization-related retained interest must be supported by objectively verifiable documentation of the interest's fair market value, utilizing reasonable, conservative valuation assumptions.

More Stringent Capital Standards Are Warranted

The banking regulators recognize the need to strengthen the capital requirement for retained interests. Retained interests serve as credit enhancements for the securitized assets. As such, these assets are considered to be recourse exposures that subject the institution to risk of loss on the transferred assets. As a result, under the current rules, risk-based capital is required for securitized assets that are deemed to be transferred with recourse due to retention of these retained interests.

The banking agencies' capital rules limit the amount of risk-based capital that a bank or thrift must hold against retained interests, as well as other recourse exposures, to no more than the amount the institution would have been required to hold against the assets sold, had those assets remained on the bank's books—typically 8 percent of the amount of the assets sold for 100 percent risk-weighted assets. This amount is known as the "full capital charge." The following illustration will clarify this concept:

> An institution has $100 in loans or other assets on its books that require a minimum of $8 in total risk-based capital. The institution sells $100 in assets, but retains a $15 recourse exposure in the form of a retained interest. Under the current capital rules, the amount of risk-based capital required would be $8, even though the bank's exposure to loss is $15. In the event the retained interest needed to be written down, the capital held against this asset may prove to be inadequate, which could pose undue risk to the bank.

On September 27, 2000, the agencies published a notice of proposed rulemaking entitled, *Capital Maintenance: Residual Interests in Asset Securitization or Other Transfers of Financial Assets.* This proposal is intended to address concerns associated with retained interests. Retained interests have exposed some institutions to high levels of credit and liquidity risk, and their values have proven quite volatile. The proposed capital treatment for residual interests would, on a net-of-tax basis:

- Require that the amount of residual interests (aggregated with certain other types of assets) in excess of 25 percent of Tier 1 capital be deducted for regulatory capital purposes, and
- Require an institution to hold a dollar in risk-based capital for every dollar in residual interests (on a net of tax basis) up to the 25 percent limit.

The "dollar for dollar" capital requirement, in tandem with the concentration limit, would ensure that adequate risk-based capital is held against retained interests and would limit the amount of retained interests that can be recognized for regulatory capital purposes. Comments from interested parties generally considered the treatment to be very conservative and recommended that the agencies restructure the proposal to target those institutions whose retained interests posed undue risk to their banking operations. Since the comment period closed on December 26, 2000, the agencies have been working to ensure that we address our supervisory concerns while being mindful of the issues raised by commenters. The agencies expect to promulgate a final rule next month.

Additional Authority for the Insurer Under PCA May Be Warranted

Prompt Corrective Action standards were intended to limit losses to the insurance funds. In some cases, the remaining capital cushion in troubled institutions will be sufficient to absorb as yet unrecognized losses. In other cases, losses embedded in troubled institutions, for example, losses which will be incurred as time passes due to poor quality of some assets already on the books, may exceed the capital cushion.

Congress and the regulators face a difficult question in determining where the capital cut-off for various types of regulatory intervention should be. The trade-off is between being careful not to seize an institution that truly possesses positive economic capital that might enable it to survive temporary financial problems, and waiting too long to act where an institution's actions may result in additional losses

to the insurance funds. This trade-off is not always simple. For example, while the FDIC's study of the last banking crisis found that there were 343 banks that failed between 1980 and 1992 that might have been closed earlier under PCA, it also found that over the same time period there were 143 banks that did not fail that might have been closed under the PCA closure rule.[5]

Under PCA, the FDIC, as deposit insurer, only has authority to take separate action against non-FDIC supervised institutions that fall into Critically Undercapitalized category. Among other things, such separate action could include restricting the institution's activities, reviewing material transactions, and approving capital plans. Institutions reach the Critically Undercapitalized level very soon before failure. Especially for institutions such as Superior, with highly volatile assets, limiting FDIC intervention to the Critically Undercapitalized level significantly inhibits our ability to direct remedial action that could minimize exposure to the funds. The FDIC believes that the deposit insurer should have additional authority under PCA rules before a non-FDIC-supervised institution becomes Critically Undercapitalized.

Regulatory Coordination Exists But Can Be Improved

The final lesson to be learned and perhaps the easiest one to resolve, is the need to improve regulatory coordination. While much discussion has focused on the supposed bureaucratic infighting between the OTS and the FDIC regarding Superior, the plain truth of the matter is that both agencies worked together for a period of well over 18 months in dealing with this troubled institution. However, in this particular case, it may be valid to argue that having two sets of eyes earlier in the process may have mitigated the loss.

Section 10(b) of the Federal Deposit Insurance Act authorizes the FDIC to conduct an examination of any insured depository institution that is not directly supervised by the FDIC if the FDIC Board of Directors finds that an examination is necessary to determine the condition of the institution for insurance purposes. Over the years, the FDIC has adopted various policies to govern special insurance examinations. The current policy, adopted on March 5, 1995, delegates authority to the Director of the Division of Supervision or his written designee to approve special insurance examinations for banks where the FDIC has been invited to participate, and, in cases where the primary Federal regulator does not object, for poorly rated (CAMELS "4" and "5") banks or banks likely to fail and for banks where material deteriorating conditions are not reflected in the current CAMELS rating. The Board must approve all other special insurance examination requests. As a result of bank and thrift failures over the past 2 years, the FDIC will review whether our own special insurance examination policy is inhibiting FDIC access to assess the risk that non-FDIC supervised institutions present to the insurance funds.

Conclusion

I appreciate the opportunity to appear before this Committee today to discuss the failure of Superior Bank and to again highlight the need for continued regulatory vigilance and more stringent accounting and capital standards for retained interest assets, particularly those related to subprime lending. I look forward to working with the Committee to see that these improvements are implemented.

Addendum to the FDIC Statement, Submitted September 11, 2001, On the Failure of Superior Bank, FSB

The FDIC previously submitted written testimony, which briefly summarized the crucial issues that make the failure of Superior of special interest to the regulators, the Congress, and the public. This addendum provides an update on some of the data reported in our previous statement, a progress report on our resolution process and the status of our rulemaking process regarding capital requirements related to securizations.

Deposits—Insured and Uninsured

At the time of closing, Superior had approximately $1.7 billion in over 91,000 deposit accounts. Of this total, approximately 94 percent of the accounts totaling $1.4 billion were initially determined to be fully insured and transferred to New Superior. The remaining 6 percent of the accounts, totaling $281 million, were considered potentially uninsured funds that required further FDIC review. The FDIC's toll-free call centers have handled over 60,000 customer inquiries through September 28. Currently, the FDIC has determined that an additional $200 million of the $281 million in deposits is insured and these funds have been released to depositors. Four percent of the $1.7 billion in total deposits have been determined to be uninsured—

[5] FDIC, *History of the Eighties—Lessons for the Future,* Vol. 1., p. 52.

a total of $64 million. The FDIC is still gathering information from depositors to review insurance coverage for the remaining $17 million in deposits to determine if those deposits may be insured. The FDIC continues to work with depositors to resolve the remaining claims and make certain insured depositors are protected.

Resolution Strategy and Management

The FDIC continues to work with the staff of New Superior to return the institution to private ownership as soon as possible. The FDIC began to contact potential bidders for the deposit franchise in mid-September. The local core deposits have stabilized at approximately $1.1 billion and we expect competitive bidding for the franchise. In early October, we completed the initial marketing and investor clearance for the sale of residuals, loan servicing, and the loan production platform. Preliminary proposals are due before the end of October with final bids due by the end of November. In addition, the FDIC has been selling loans from New Superior's portfolio—$170 million in loans sold through October 10, with an additional $310 million in additional loans on the market with their sale likely by the end of November. We are scheduled to receive bids for the Superior deposits on October 25 and expect to start returning the deposits and assets to the private sector in November with completion by year-end. We will have a better estimate of the cost to the SAIF upon the final resolution of the conservatorship.

To support New Superior's ongoing operations, the FDIC made available a $1.5 billion line of credit. Through October 5, the FDIC had advanced $829 million to New Superior to maintain an appropriate liquidity cushion and finance operations. To date, New Superior has repaid $89 million of that total, leaving $740 million in outstanding advances. We anticipate substantial repayments to the line of credit as operations continue.

Capital Standards for Securitization of Loans

As noted in our earlier submission to the Committee, the banking regulators recognize the need to strengthen the capital requirement for retained interests. The "dollar for dollar" capital requirement, in tandem with the concentration limit, would ensure that adequate risk-based capital is held against retained interests and would limit the amount of retained interests that can be recognized for regulatory capital purposes. The FDIC and other banking regulators now anticipate that the final rule on the capital treatment of recourse, direct credit substitutes, and residual interests in asset securitizations will be published in the *Federal Register* in late November. The FDIC Board is scheduled to consider the final rule at our Board Meeting on October 23. The final rule contains an effective date of January 1, 2002, and provides for a one year transition period for transactions prior to that date.

PRPEPARED STATEMENT OF BERT ELY

PRESIDENT, ELY & COMPANY, INC.

OCTOBER 16, 2001

Mr. Chairman and Members of the Committee, I want to thank you for the opportunity to testify today regarding the July 27, 2001, failure of the Superior Bank, FSB, which was headquartered in Oakbrook Terrace, Illinois. My testimony will address several issues regarding the Superior failure: My theory as to why Superior failed, a review of the regulatory shortcomings that led to this very expensive failure, broader regulatory problems that have been quite evident in some very expensive bank and thrift failures in recent years, and legislative recommendations to at least lessen these problems, if not eliminate them.

Before continuing, Mr. Chairman, I want to commend you for starting this hearing on September 11 even though news had reached us of the terrorist attacks that had already struck New York and the Pentagon that morning. Although those attacks shut down Washington that day and forced the postponement of this hearing, they did not shut down America nor our Government, as our attendance here this morning attests. My testimony this morning benefits from the opportunity to have reviewed the written statements Ellen Seidman, Director of the Office of Thrift Supervision (OTS), and John Reich, Director of the Federal Deposit Insurance Corporation (FDIC), submitted for the September 11 hearing.

Why Superior Failed

Superior, under the Pritzker/Dworman ownership, was created at the end of 1988 as the successor to the failed Lyons Federal Bank, FSB, one of the infamous S&L resolutions that year. Like many other 1988 S&L resolutions, Superior started life

with enormous tax benefits and a substantial amount of FSLIC-guaranteed assets under a FSLIC Assistance Agreement. However, Superior could not profit indefinitely from its FSLIC launch. As Mr. Reich noted in his September 11 statement, Superior was a "troubled thrift" in the late 1980's and early 1990's. In order to survive, Superior had to develop a long-term business strategy. Enter Alliance Funding, Superior's wholesale mortgage origination division, which Superior acquired at the end of 1992 "from an affiliate," as Ms. Seidman noted in her September 11 statement. With Alliance on board, Superior became a one-trick pony that was doomed to stumble, fatally, one day, or in this case 8½ years later.

Superior's trick, or business plan, was to concentrate on subprime lending, principally on home mortgages, but for a while in subprime auto lending, too. Subprime loans generally are those made to borrowers evaluated as B, C, and D credit risks while prime loans are made to A-quality credit risks. While Superior originated loans as a retail lender in the Chicago area, that is, making loans directly to consumers through its own offices, my sense is that it originated or purchased most of its loans through Alliance, which is headquartered in Orangeburg, New York, outside of New York City, in Rockland County. Working from its home office and 10 branches around the country, Alliance either purchased loans originated and funded by independent mortgage bankers or it funded in its own name mortgages originated by mortgage bankers and brokers. In effect, Alliance vacuumed up subprime loans across the country for later securitization. It appears that Superior became a dumping ground for low-quality, and possibly predacious, mortgages that brokers could not sell elsewhere. There also are reports that Superior loosened its loan underwriting standards in 1999 to attract additional mortgage business.

I encourage Committee Members and their staff to visit the Alliance website, *www.allfun.com,* to get a full flavor of the types of mortgages in which Alliance specializes. The following list highlights some of Alliance's lending programs as they existed on July 31, 2001, just after the FDIC took over Superior: "limited and no credit borrowers," "mortgage down 3 months or foreclosures," "80 percent LTV for recent discharge from Bankruptcy," "borrowers cannot source down payment," "fixed income is grossed up 135 percent," "full array of options for stated income and limited documentation borrowers," "highest LTV's in the industry for rural properties," "open Chapter 13 Bankruptcies at 75 percent LTVV" "second homes are considered owner-occupied," "second mortgage behind private allowed," and so forth. Some of Superior's riskiest products have been dropped from the Alliance website since the FDIC took over Superior, a strong indication of Superior's highly risky lending. In addition to mortgages, Superior also engaged in subprime auto lending, most heavily in 1998 and 1999, with a substantial phase-down of that business in 2000. I do not wish to condemn subprime lending in general, but clearly Superior engaged in especially high-risk subprime lending that ultimately was its downfall.

Briefly, Superior appears to have adopted this business model:

- Vacuum up subprime mortgages, and originate a few, too;
- Warehouse the mortgages on the Superior balance sheet, using insured deposits to fund that warehouse;
- Service the mortgages;
- Periodically securitize some of the mortgages, usually on a quarterly basis, while retaining the servicing rights to them;
- Sell the mortgages, for securitization purposes, for more than they really are worth, but hide that fact by taking back interest-only strip receivables and other securitization residuals that can be treated on Superior's balance sheet as an asset. As Ms. Seidman noted in her September 11 statement, "Superior, like many issuers, hold on to the security with the greatest amount of risk or otherwise provided significant credit enhancement for the less risky securities." In effect, the retained interests in the securitized mortgages represented a hidden price discount to facilitate their sale;
- By selling mortgages for more than they really are worth, report excessive profits or gains on the sale of those mortgages for securitization purposes; and
- Report artificially high net income, because of excessive gain-on-sale income, which enables substantial dividend payouts, as well as the appearance of high capital levels.

Evidence from Superior's Thrift Financial Reports (TFR), which Superior filed quarterly with the OTS, supports this theory:

- Superior first reported gain-on-sale income in 1993, the first full year after Superior's December 31, 1992, acquisition of Alliance Funding.
- From 1994 to 1999, Superior's gain-on-sale income increased each year. For the 5 years from 1995 to 1999, Superior's gain-on-sale income totaled $487 million, $72 million *more* than Superior's pretax income. In effect, Superior consistently

lost money before taking into account its gain-on-sale income. For the thrift industry as a whole, less Superior, gain-on-sale income usually equals about 10 percent of pretax income.

- Starting in 1993, Superior began accumulating the types of assets associated with retained interests in mortgage securitizations. While the precise amount of these assets cannot be determined from Superior's TFR's, the balance sheet categories in which these assets are placed accounted for an increasing proportion of Superior's assets.[1] Assets in these categories rose from 20 percent of Superior's total assets at the end of 1992 to 34 percent the following year-end, to 56 percent in 1996, 60 percent the following year, and to a peak of 65 percent at the end of 2000. While this percentage has been rising for the thrift industry as a whole, the industry percentage has been much lower; for example, it rose from 9 percent at the end of 1997 to 13 percent at the end of 2000.
- As Ms. Seidman noted in her September 11 statement, "large residual positions often serve as a signal of the lower credit quality of the sold assets." As she also noted, "residuals generally have no liquid secondary market, [so] 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." She further observed that "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 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."
- Superior paid $188 million in dividends in the 1989–1999 period, which gave Superior's stockholders an 18.1 percent pretax cash return on their initial investment of $42.5 million in Superior. These stockholders also may have reaped additional profits from the substantial tax benefits the Federal Government gifted to them when they acquired Lyons.
- Despite its substantial dividend payments, Superior accumulated an impressive amount of capital on its balance sheet through the retention of reported earnings. From $59.4 million at the end of 1992, equal to 6.1 percent of its assets, Superior's book capital rose to $297.6 million at the end of 1999, equal to 13.8 percent of its assets. As Ms. Seidman noted in her September 11 statement, "some institutions have been able to use residual interests and gain-on-sale accounting (for example, the immediate recognition of the present value of expected future cash flows) to improve their capital positions."
- Superior's tax benefits as successor to the defunct Lyons Savings Bank helped this capital accumulation. From 1992 to 1998, Superior reported pretax income of $289.7 million on which it claimed a Federal tax *credit* of $10.6 million. Only in 1999, did Superior begin to pay a meaningful amount of Federal income tax, However, Superior's capital was a mirage, for in 2000, Superior's reported equity capital shrank $260 million, to $38 million (1.8 percent of assets), largely due to "other adjustments" in its capital accounts in the fourth quarter of 2000. This reduced capital percentage made Superior "critically undercapitalized" under the Prompt Corrective Action standards for regulatory intervention established in the FDIC Improvement Act of 1991.

Regulatory Shortcomings That Led to a Very Expensive Failure

Superior's regulators, and specifically the OTS, failed miserably in their supervision of Superior. Hopefully, the forthcoming inspector general and General Accounting Office reports on the Superior failure will provide a detailed insight into and documentation of these failings. However, even now important conclusions can be drawn from the public record, specifically from Superior's TFR's. My key conclusions are as follows:

- The OTS failed to recognize the fundamentally flawed business model Superior adopted when it acquired Alliance Funding at the end of 1992. Instead, OTS appears to have permitted Superior to pursue that model for over 8 years, until its closure on July 27. The preceding section of this testimony summarizes that flawed business model.
- The linchpin of Superior's flawed model, as Ms. Seidman noted, was retaining the riskiest or worst portion of its asset securitizations. Hence, we see the steady buildup of dubious, nonmainstream-thrift types of assets on Superior's balance sheet. Worse, it appears that these assets were consistently overvalued for many years. Had the OTS taken the initiative to independently establish conservative valuations of Superior's securitization-related assets, Superior would have been

[1] The balance sheet categories are: mortgage derivative securities, other mortgage pool securities, interest-only strip receivables and other instruments, and all other assets.

forced to adopt a more profitable business model or sell itself to a stronger financial institution. The First National Bank of Keystone failure on September 1, 1999, should have immediately set the OTS alarm bells ringing about Superior since it owned a far larger amount of residual interests than did Keystone.

- The OTS apparently failed to appreciate the extent to which Superior was an outlier among thrifts—it was far from being the typical post-FIRREA thrift. For example, at the end of 1997, almost 4 years before Superior failed, it had almost seven times as much invested in the asset categories containing securitization-related assets, per dollar of total assets, as did the rest of the thrift industry. For 1997, Superior's gain-on-sale income, per dollar of pretax income, was twelve times the industry average that year. Most startling, at the end of 1997, Superior's recourse exposure related to assets sold, per dollar of capital, was *31 times* the industry average. Even a rudimentary comparative analysis of Superior's TFR data with thrift industry data should have flagged it as an outlier worthy of special attention years before it failed. For these reasons, it is absolutely astounding and quite troubling that the OTS in October 1997 *raised* Superior to a CAMELS "1" composite rating from a CAMELS "2" rating and stayed at that level until March 1999.
- It is not at all clear if Superior was reserving adequately for future loan charge-offs and asset writedowns on a timely basis, particularly toward the end. Any underre-serving for future charge-offs and writedowns, of course, would be another factor causing Superior's capital to be overstated.
- In a throw-back to the S&L crisis, Superior appears to have relied to a great extent on nonretail deposits to fund the growth of its securitization-related assets. My rough estimate is that less than half of Superior's deposits were genuine retail deposits held by individuals and businesses located within a reasonable proximity of Superior's 17 branches. At June 30, 2000 (the last date for which branch deposit data is available), Superior's La Grange Branch reported $827 million in deposits while its Berwyn and Downers Grove branches reported deposits of $143 million and $123 million, respectively.[2] They are hardly your typical retail branch. Also, Superior started attracting brokered deposits in 1998 but brokered deposits declined significantly during 2000 from $403 million at the end of 1999; they had dropped to $81 million by June 30, 2001. According to Ms. Seidman, OTS told Superior in the spring of 2000 to stop accepting or rolling over brokered deposits.
- Especially troubling was Superior's gathering of uninsured deposits. Superior significantly increased its uninsured deposits in 1998, the year it began taking brokered deposits as it grew its assets from $1.3 billion to $1.8 billion. Uninsured deposits jumped in 1998 from $93 million to $316 million and then rose to $569 million by the end of 1999 before hitting a quarterly peak of $572 million on March 31, 2000. After dropping $80 million over the next 6 months, uninsured deposits went into a free-fall, plunging $440 million, or 89 percent, from last September 30 to March 31 of this year. This drop may reflect a correction of past accounting errors,[3] apparently a frequent problem at Superior, or a genuine run by larger depositors. I trust the Inspectors General and the GAO will investigate what sparked that drop. I am even more troubled by the almost obscene *increase* in Superior's uninsured deposits during the second quarter of this year, when they rose $9.6 million. Had the OTS moved more quickly to close Superior, those new uninsured depositors would not have suffered any loss. As it is, they will suffer a significant loss.
- A major problem any outsider experienced in trying to assess Superior's true condition were the often erroneous TFR's Superior filed with the OTS. In reviewing Superior's TFR data, as made available on CD's sold by Sheshunoff & Company, I have found numerous inconsistencies and unreconciled differences in Superior's financial data that stem from the quiet filing of amended TFR's. For example, until the March 31, 2000, TFR Superior had reported no interest-only strip receivables. Suddenly, on that date, Superior report $644 million of interest-only strips, which accounted for 28 percent of its total assets. Previously, those interest-only strips appear to have been classified on Superior's TFR's as "mortgage derivative securities."

  A far more egregious reporting incident occurred for the fourth quarter of 2000. Superior's initial TFR for December 31, 2000, reported that it had $255.7 million in capital on the date, for an 11.2 percent leverage capital ratio, which is quite

[2] FDIC's annual Summary of Deposit data by bank and thrift branch can be found at *www.fdic.gov.*

[3] Ms. Seidman makes numerous references in her September 11 statement to Superior's erroneous financial statements, including references on pages 16, 17, 19, and 22.

strong. However, on March 2 of this year, Superior filed an amended TFR[4] showing $37.9 million of capital, for a capital ratio of just 1.8 percent, which means that Superior was "critically undercapitalized" at the end of last year. This data may not have been published on the FDIC website until as late as June of this year. Quite possibly, uninsured depositors in Superior were misled by that initial TFR. Over the years, OTS failed badly in ensuring that Superior filed accurate TFR's the first time.

- Despite TFR inaccuracies and overvalued assets, it was possible to determine that Superior was deeply insolvent as early as last September 30. Based on Superior's TFR data as of that date, I sent a letter to Ms. Seidman on February 9 of this year warning her about Superior's looming insolvency; a copy of that letter is attached to this testimony. OTS never replied to my letter. The rest is history. What is particularly troubling about that history is Superior's rapid deterioration after September 30 and even more so after the first of this year. Superior's reported capital ratio declined sharply, from 13.5 percent on September 30 to 3.1 percent on March 31, 2001.

  Even that capital percentage was overstated, for as Ms. Seidman notes, on March 30, 2001, one day before the end of the quarter, Superior's parent holding company 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." In fact, without this capital infusion of residual interests with an "estimated value of $81 million," Superior would have reported a *negative* net worth of $20 million on March 31, 2001. Of course, Superior's reported negative capital of $197 million on June 30 of this year strongly suggests that Superior's capital was grossly overstated on March 31, and much earlier.
- Other measures suggest declining asset quality. For example, unpaid interest on mortgages Superior owned rose from 1.1 percent last September 30 to 4.7 percent on March 31 of this year; the thrift industry average on March 31 was .58 percent. This disparity suggests that Superior was experiencing a substantial increase in delinquencies in its mortgage portfolio. A similar deterioration was observed for loans Superior was servicing for others, which largely consisted of loans it had securitized. Advances by Superior on these loans to pay principal, interest, taxes, and insurance rose steadily, from 1.5 percent at the end of 1999 to 1.9 percent on September 30, 2000, to 2.1 percent at the end of 2000, to 3.0 percent on March 31, 2001, and to 3.2 percent on June 30, 2001. This rising percentage strongly indicates a deterioration in the loans Superior has securitized, which suggests a further impairment in the value of Superior's securitization-related assets. As Ms. Seidman noted, seller-servicers of subprime loans, such as Superior, "may be able to mask losses by artificially keeping loans current through servicer advances."
- OTS added to Superior's insolvency loss by moving far too slowly to close the institution. The slow, drawn out closure process is summarized in Ms. Seidman's September 11 statement. What is particularly troubling is the extent to which the OTS was willing, during extended discussions with the Pritzker interests, to engage in a window-dressing exercise to punt Superior's eventual insolvency far into the future. Two sentences in Ms. Seidman's statement are especially telling in this regard: "OTS indicated that, even under the most extreme case set forth in the Pritzker's [sic] modified projections, it appeared that the concerns expressed by the Pritzker interests would not be an issue until many years later . . . 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" proposed by the Pritzkers. *Shades of the S&L crisis!*
- The FDIC is not fault-free in this situation, Although the FDIC reportedly raised concerns about Superior in December 1998, when it sought to examine Superior, and was denied by the OTS, one must still wonder if the FDIC pounded the table hard enough in closed-door meetings of the FDIC Board (on which Ms. Seidman sits) about Superior's declining condition. Given the depth of Superior's insolvency, one can reasonably wonder if the FDIC pushed hard enough for an earlier closure of Superior, particularly since (1) the FDIC "did not like the [Superior] recapitalization plans[5]" and (2) FDIC personal were at Superior continually, starting 96 days before Superior was closed.[6] Also, given the FDIC's long-standing concerns about Superior and its eventual access to the institution, the FDIC seems not to have been prepared for OTS's decision to close Superior. In effect, the FDIC appears to have not developed a "Plan B" to execute immediately if the

[4] Ms. Seidman's September 11 statement.
[5] *American Banker,* August 9, 2001.
[6] *American Banker,* August 21, 2001.

OTS's "Plan A," the Pritzker/Dworman recapitalization of Superior proposed on May 24, 2001, fell through.

This unpreparedness is evidenced by the FDIC's decision to continue operating Superior in a conservatorship rather than to immediately sell its branches, its retail deposit franchise, and what few good assets Superior has. However, it is highly unlikely that a single buyer will purchase all of Superior's good assets. Most likely, a Chicago-area depository institution will purchase the Superior branches while a subprime mortgage specialist will purchase Alliance Funding and Superior Servicing, Superior's servicing arm. Although it can never be calculated, the FDIC probably has increased the eventual Superior insolvency loss through its bungling of the Superior closure.

The OTS summed up quite well Superior's numerous shortcomings in a news release it issued on July 27, 2001, the day it closed Superior:

> "Superior Bank suffered as a result of its former high-risk business strategy, which was focused on the generation of significant volumes of subprime mortgage and automobile loans for securitization and sale in the secondary market. OTS found that the bank also suffered from poor lending practices, improper recordkeeping and accounting, and ineffective board and management supervision. Superior became critically undercapitalized largely due to incorrect accounting treatment and aggressive assumptions for valuing residual assets."

Ms. Seidman, in testimony delivered to the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee just 31 hours before she closed Superior suggested that "certain types of nontraditional smaller institutions" could fail suddenly. Although she may have had Superior in mind that day, that statement certainly is not applicable to Superior. Superior did not fail suddenly nor was its failure a surprise, for it planted the seeds of its self-destruction 8½ years earlier. *The fundamental question which must be asked, and answered: Why did the OTS tolerate that self-destructive business strategy?*

Broader Bank Regulatory Problems That Have Become Quite Noticeable In Recent Years

From the beginning of 1995 to last Friday, there have been 35 bank and thrift failures, 33 of which caused a loss to the BIF and/or the SAIF. Attached to this testimony is a table listing these 35 failures. Losses range in size from an estimated $80,000 to $813 million, the latest loss estimate for the Keystone fiasco.[7] Although the FDIC has not yet announced a loss estimate for the Superior failure, I plugged a $750 million figure in the table, which reflects my gross loss estimate of approximately $1 billion less that portion of the loss that will be borne by uninsured depositors and general creditors as well as litigation recoveries, net of litigation expenses. As the table shows, three failures—Superior, Keystone, and BestBank—account for $1.79 billion, or 87 percent, of estimated BIF/SAIF losses over the last 6¾ years.

The loss *amount* in these three failures, which also happen to be the three largest institutions to fail, is so high largely because the insolvency loss *percentage* in these failures is so high, ranging up to 78 percent in the Keystone caper. BestBank had the fourth-highest loss percentage, 61 percent, while Pacific Thrift and Loan Company, with the fourth-highest loss amount, experienced the second-highest loss percentage of 67 percent. Superior appears to come in sixth, at 42 percent, although that percentage will change as the FDIC gets a better fix on Superior's ultimate loss amount. Two small institutions, Union Federal Savings Bank and Commonwealth Thrift and Loan, also had high loss percentages—62 percent and 44 percent, respectively. Had the loss percentage in the four most costly failures been held to 30 percent—still a high percentage, especially for larger institutions—the insolvency loss in these four cases would have been trimmed by $860 million, or 42 percent of the FDIC's insurance losses since 1995.

Four charts appended to this testimony graphically place these expensive failures in perspective with other bank and thrift failures. FIGURE 1 contrasts the handful of extremely expensive failures since 1995 with the multitude of relatively inexpensive failures. FIGURE 2 presents this contrast in another manner, as a stacked bar. FIGURE 3 shows a distribution of FDIC insolvency losses as a percentage of assets in the failed institutions. FIGURE 4 ranks the 10 most expensive FDIC-insured failures since 1986 based on their insolvency loss as a percentage of total assets. Although Superior and Keystone were the smallest two of these 10 institutions, in

[7] The amount of the FDIC's subrogated claim in the Keystone receivership, as shown in the FDIC Statement of Assets and Liabilities in Liquidation (Unaudited) for Keystone for the period ending August 31, 2001.

terms of assets at the time of failure, they made the "top ten" list because of their high-loss percentages.

It is clear from the table and the charts that there have been numerous instances, even among small institutions where high loss percentages can reasonably be expected, where the loss percentage has been fairly low—under 10 percent or 20 percent. It is not unreasonable to classify low-cost failures of smaller banks and thrifts as the occasional "fender-benders" of the deposit insurance business. Of the 35 FDIC-insured failures since the beginning of 1995, I have characterized 23 of them as fender-benders.[8]

Failures with high loss percentages, including the cases I just cited, strongly suggest that at least some of the time the regulators have moved far too slowly in getting a bank or thrift turned around, recapitalized, sold, or closed. This is a troubling situation that could worsen as the economy slides into a recession. Therefore, the four Federal bank regulatory agencies[9] should get much more aggressive and move much more quickly to resolve problem situations before they create an insolvency loss. Given the insolvency risk of trying to save a weak bank or thrift so that it can remain independent, regulators should become much more aggressive in forcing weak institutions to merge into stronger institutions or to liquidate prior to insolvency, as Pacific Southwest Bank, FSB, did earlier this year.

One troubling thread running through some of the most expensive failures was a bank management team that vigorously fought efforts by examiners trying to gain a good understanding of the bank's financial condition and operating practices. That clearly was the case in the BestBank and Keystone failures. Apparently that happened to some extent at Superior. According to an article in the September 7, 2001, *American Banker,* Ms. Seidman stated at a news conference the previous day that OTS examiners "were confronted with a management that was 'fighting back hard' against the [OTS's] criticisms." It amazes me that examiners were cowed in these situations given that that type of resistance often signals severe problems in the institution. Instead of being cowed, examiners who face a management "fighting back hard" should dig even harder and deeper to uncover the problems the management obviously is hiding.

What is especially troubling in the most costly failures has been the amount of buck-passing and finger-pointing by the regulators, specifically in asserting that it is up to a bank's or thrift's outside auditors to detect fraud and properly value assets. In the Superior case, the OTS has been especially vociferous in asserting that Ernst & Young, Superior's auditors, was slow to properly value the securitization residuals on Superior's balance sheet.[10] See, for example, Ms. Seidman's unsubstantiated assertion in her statement that "the concentration of residuals at Superior was exacerbated by a faulty accounting opinion by the institution's external auditors that caused [Superior's] capital to be significantly overstated."

In fact, fraud detection and asset valuation are absolutely central to the effective examination and supervision of depository institutions. Given the importance of these activities, bank regulators must make reasonable efforts to detect fraud and to properly value assets, with their own staffs or outside contractors, rather than relying on independent parties, such as an institution's accounting firm. I estimate that Superior paid the OTS $760,000 in 2000 in examination fees, as well as substantial fees in earlier years. Those sums certainly were sufficient to permit the OTS to obtain the assistance of outside experts in periodically estimating the value of Superior's securitization-related assets. Any plea by the OTS that it was hamstrung by Ernst & Young in valuing Superior's residual interests is patently absurd.

Most disturbing is the sense that the Federal bank regulators neither embrace nor even understand their fiduciary obligation to the banking industry to minimize insolvency losses without being unduly restrictive of banking activities. Regulators owe this fiduciary obligation because it is the banking industry, through past and future deposit insurance assessments, and not taxpayers, who stand first in line to pay for regulatory failure. Good banks and thrifts do not let bad institutions fail, regulators do. If the regulators do a good job of protecting bankers' pocketbooks, the taxpayer will automatically be protected.

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[8] A deposit insurance fender-bender is rather arbitrarily and liberally defined as (1) a failed institution with less than $50 million in assets and an insolvency loss percentage below 30 percent, (2) an institution with assets between $50 million and $100 million and a loss percentage below 20 percent, or (3) an institution with more than $100 million of assets and an insolvency loss below $5 million.

[9] Federal Reserve Board, Comptroller of the Currency, FDIC, and OTS.

[10] From 1964 to 1966, I was on the audit staff of Ernst & Ernst, a predecessor firm to Ernst & Young. I have no ties to Ernst & Young at this time.

This absence of a sense of fiduciary obligation raises this question—why are regulators not concerned about the impact of their failures on deposit insurance assessments? Partly it may be regulatory tradition and a lack of personal accountability on the part of senior regulatory management. After all, how many senior regulators have been fired over the last 20 years because of the almost 2,800 bank and thrift failures that have occurred? But there may be another reason, particularly at the OTS, for this lack of fiduciary obligation, and that is survival of the OTS, which is dependent upon its ability to generate examination fees. According to OTS financial statements posted on www.ots.treas.gov, the OTS slid from an $18 million profit in 1996 to a $13 million loss in 2000. According to an August 28, 2001, *American Banker* article, the OTS projects that it will return to profitability in 2003. Perhaps it will, but maybe it will not as the number of thrifts continues to decline. One can reasonably wonder if the prospective loss of $760,000 annually in exam fees deterred senior OTS management from moving more quickly to close Superior.

One additional point merits a mention in this discussion of broader regulatory problems that Congress should ponder, and that is the concept of depositor discipline. The notion of depositor discipline is the rationale for a deposit insurance limit, on the theory that large, uninsured depositors, armed with accurate, timely information about a bank's condition, will run from a weak institution, thereby ringing an alarm bell to wake up sleepy regulators. As I noted above, there appears to have been a substantial run by uninsured depositors from Superior last winter. What triggered this apparent run is a mystery, as is its effect on the OTS. Assuming a 40 percent loss rate, those uninsured depositors who fled Superior from last October to March of this year escaped a $175 million loss. As it is, the 816 depositors holding $66.4 million of uninsured deposits when Superior was closed [11] (an average of $81,400 per depositor) face a loss in the $25 million range. How could large depositors, such as a former parcel deliverywoman who deposited a $145,000 disability payment in Superior the day before it closed,[12] determine the true state of Superior's financial condition based on then publicly available TFR's?

Many believe that deposit insurance creates a moral hazard, in that insured depositors care not a whit about a bank's or thrift's financial condition. But regulatory moral hazard trumps depositor moral hazard if regulators publish erroneous information on which to judge an institution's condition, as OTS did in the Superior situation, or if regulators inexplicably drag their feet in closing an insolvent institution, as the OTS did in the Superior situation. Although seldom discussed, regulatory moral hazard is the real issue Congress must now address, not depositor moral hazard. Attached is an article of mine, "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance," which provides insights into this problem.

Legislative Recommendations

Superior's failure teaches many lessons, and will teach more as its causes become better understood. However, from both a legislative as well as a regulatory perspective, it is important not to draw the wrong conclusions from these lessons and accordingly enact new laws and adopt new regulations that will worsen matters. The following are my legislative recommendations stemming from the Superior failure:

- Require regulators to more frequently and conservatively value risky assets. While Generally Accepted Accounting Principles, or GAAP, represent a good starting point in establishing asset values, GAAP should not straitjacket regulators if they conclude, after conducting the appropriate analyses, that GAAP overstates the value of an asset. In such cases, the regulators should require that an asset's value be reduced, at least for regulatory accounting purposes. This approach would be much better than higher capital requirements on risky types of assets. While it is much easier to set higher uniform capital standards, those standards will (1) drive less risky assets off bank balance sheets (this is called "regulatory arbitrage"), and (2) postpone the day when asset values, and therefore capital levels, are realistically recognized on an institution's balance sheet. Also consider barring a financial institution from retaining any portion of its asset securitizations so a true market value is established for assets when they are sold.
- Do *not* raise capital standards for intervention under Prompt Corrective Action as that will not make a meaningful difference in preventing bank and thrift failures with high-loss percentages. However, higher intervention standards could cause sound, well-run banks and thrifts to overcapitalize themselves, which would drive lower-risk assets off of bank balance sheets (another form of regulatory arbitrage).
- Empower the FDIC to levy losses above a certain percentage of a failed institution's assets—say above 20 percent or 30 percent—on the chartering agency of the

[11] *American Banker,* August 14, 2001.
[12] Ibid.

bank. The agency would then have to pass that levy back to the institutions it has chartered through higher exam fees. The institutions chartered by that agency would then have a powerful incentive to pressure the agency's top management to prevent future high-loss-percentage failures.

- Provide for tough personal sanctions and job terminations for high level personnel in the agency or agencies responsible for the supervision of a failed institution with a high-loss percentage. While a failed institution's management is directly responsible for its failure, the institution's regulators must be held personally accountable if the subsequent insolvency loss is too high. With the onset of a recession in the aftermath of the September 11 terrorist attacks, it has become more imperative than ever that the regulators move quickly to resolve troubled institutions through a merger, sale, recapitalization, or all else failing, closure. Under no circumstance should a banking regulator delay resolving an institution while trying to "save" it.
- Require the bank regulatory agencies to develop the capabilities—either internally or under contract—to detect fraud and to value all types of bank and thrift assets. While regulators should review reports from a bank's or thrift's outside auditors to gain an additional perspective on the institution, regulators should *not* place any reliance on audit reports for either examination or supervisory purposes. I was greatly troubled to read in Ms. Seidman's statement that an OTS examiner is "usually not an accountant." In fact, accounting skills are an essential requirement for conducting good safety-and-soundness examinations.
- Strengthen the FDIC's intervention powers, particularly when off-site monitoring suggests a lower CAMELS rating than the chartering agency has established. At a minimum, FDIC personnel should be able to accompanying another agency's examiners on an already-scheduled examination without the consent of the other agency. However, because examinations are disruptive to banks and thrifts, the FDIC should not be given the authority to conduct backup exams on its own initiative. If a chartering agency refuses to let the FDIC do a back-up examination, the agency should be required to give the FDIC a confidential memorandum explaining the reasoning behind its denial. If the institution later fails with a high-loss percentage, then that memorandum should be taken into consideration in determining how best to discipline senior management of the chartering agency (see above).
- Give the FDIC greater power to force the closure of State-chartered institutions. Under no circumstances should a State banking department have final authority over the closure of a bank or thrift whose insolvency would cost the participants in a Federally administered deposit insurance program. If a State government wishes to retain the ultimate closure decision, then it should reimburse the FDIC for any insolvency loss the FDIC might otherwise incur.
- Acknowledge that sufficiently high-risk-sensitive premiums, levied on the basis of leading indicators of banking risk, would provide weak banks with a powerful financial incentive to recapitalize or sell before insolvency is reached. An injection of capital should lead to a sufficient lowering of premiums to pay for that additional capital. That incentive might be more successful in avoiding insolvency losses than relying upon banking supervisors to turn around 4- and 5-rated banks. In this regard, I was quite troubled to read in the FDIC's recommendations for deposit insurance reform,[13] on pages 8, 11, and 13, that the FDIC rejects the idea of charging the riskiest banks and thrifts the full amount of the premium they should pay, based on the FDIC's loss experience. The statement on page 13 of the FDIC report, "there is a concern that premiums could get so high that they could push institutions that might otherwise have survived into failure," reflects a fundamental misunderstanding of the role that risk-sensitive deposit insurance premiums should play, which is to force the resolution of a problem.
- Do *not* permit the FDIC to rely upon reinsurance premium rates to establish risk-sensitive premium rates for large banks as those rates will be too high given that a reinsurer must not only take into account the risk that a bank will become insolvent, but also the possibly greater risk the chartering agency will be slow to close a failing bank. Superior amply demonstrates the closure risk any reinsurer faces.
- There should be public notification of the filing of amended TFR's and bank call reports to alert depositors and outside analysts to a possible decline in a bank's or thrift's financial condition. If depositor discipline is ever to be meaningful, particularly for banks and thrifts which do not file financial statements with the Securities and Exchange Commission, then it is absolutely vital that depositors

[13] "Keeping the Promise: Recommendations for Deposit Insurance Reform," Federal Deposit Insurance Corporation, April 2001.

have access to timely, accurate information with which to assess a bank's or thrift's financial condition and probability of failure.

- These recommended reforms ultimately may not be sufficient to overcome regulatory moral hazard, in which case the Congress should pursue more fundamental reforms. Former Treasury Department General Counsel Peter J. Wallison proposed in an attached April 27, 2001, op-ed in the *American Banker*, headlined "Industry, Not Government Is the Real Deposit Insurer," that the banking industry "establish the loss reduction policies that the FDIC enforces—especially those concerning bank examinations and insurance premiums." I go one step further in advocating the cross-guarantee concept to delegate to the private sector the full responsibility for ensuring the safe-and-sound operation of banks and thrifts. This concept is summarized on pages 251 and 252 in my "Regulatory Moral Hazard" article cited above.

Conclusion

The Superior Bank failure is quite troubling, coming on the heels of the unnecessarily expensive Keystone and BestBank failures. I urge Congress to probe deeply into the regulatory failings leading up to these failures and to respond to their causes and not their symptoms.

Mr. Chairman, I thank you again for the opportunity to testify today in this most important matter. I welcome your questions and questions from your colleagues.

FDIC insured bank and thrift failures since 1995.
Dollars in millions

No.	Failure Date M	D	Year	Name	ST	Fund	Primary Regulator	Total Assets	Total Deposits	Estimated Insolvenc Loss	Assets/ Loss	Fender Bender	Savings if loss % cut to 30%
1	1	20	1995	Guardian Bank	CA	BIF	Fed	277,481	193,600	20,989	7.6%		
2	3	3	1995	First Trust Bank	CA	BIF	FDIC	204,123	197,200	25,627	12.6%		
3	3	21	1995	Los Angeles Thrift and Loan	CA	BIF	FDIC	21,476	21,900	6,067	28.3%	Yes	
4	5	19	1995	Bank USA, N.A.	HI	BIF	OCC	9,361	8,900	2,593	27.7%	Yes	
5	7	28	1995	Founders Bank	CT	BIF	FDIC	77,417	72,700	10,374	13.4%	Yes	
6	7	28	1995	Pacific Heritage Bank	CA	BIF	FDIC	153,570	138,400	19,407	12.6%		
7	3	8	1996	Metrobank of Philadelphia, N.A.	PA	BIF	OCC	35,023	33,630	7,701	22.0%	Yes	
8	5	1	1996	People's Bank and Trust	TX	BIF	FDIC	19,981	18,788	3,378	16.9%	Yes	
9	6	14	1996	First National Bank of Panhandle	TX	BIF	OCC	62,719	57,905	16,038	25.6%		
10	7	12	1996	Fairfield First Bank & Trust	CT	BIF	FDIC	51,278	47,655	5,663	11.0%	Yes	
11	8	9	1996	Union Federal Savings Bank, FSB	CA	SAIF	OTS	35,140	32,189	21,921	62.4%		
12	8	16	1996	Commonwealth Thrift and Loan	CA	BIF	FDIC	12,731	10,250	5,640	44.3%		
13	11	21	1997	Southwest Bank	LA	BIF	FDIC	25,830	26,800	5,026	19.5%	Yes	
14	4	9	1998	Omnibank	MI	BIF	Fed	38,316	36,322	2,866	7.5%	Yes	
15	7	23	1998	BestBank	CO	BIF	FDIC	379,013	285,657	231,201	61.0%		117,497
16	8	7	1998	Q Bank	MT	BIF	Fed	14,406	13,097	1,590	11.0%	Yes	
17	3	26	1999	Victory State Bank	SC	BIF	FDIC	12,288	11,082	0	0.0%	Yes	
18	4	23	1999	Zia New Mexico Bank	NM	BIF	Fed	13,565	12,604	2,222	16.4%	Yes	
19	7	9	1999	East Texas National Bank	TX	BIF	OCC	113,860	100,470	8,632	7.6%		
20	7	9	1999	Oceanmark Bank, a FSB	FL	SAIF	OTS	62,956	63,427	3,127	5.0%	Yes	
21	9	1	1999	First National Bank of Keystone	WV	BIF	OCC	1,045,861	921,971	812,826	77.7%		499,067
22	9	10	1999	Peoples National Bank of Commerce	FL	BIF	OCC	34,790	33,558	3,094	8.9%	Yes	
23	11	11	1999	Pacific Loan and Thrift Company	CA	BIF	FDIC	69,294	107,198	46,168	66.7%		25,399
24	12	10	1999	Golden City Commercial Bank	NY	BIF	FDIC	88,244	81,268	0	0.0%	Yes	
25	1	14	2000	Hartford-Carlisle Savings Bank	IA	BIF	FDIC	113,311	71,337	11,127	9.8%		
26	3	10	2000	Mutual Federal Savings Bank	GA	SAIF	OTS	29,530	28,583	1,075	3.6%	Yes	
27	6	2	2000	Monument National Bank	CA	BIF	OCC	10,325	10,116	748	7.2%	Yes	
28	7	14	2000	Town and Country Bank of Almelund	MN	BIF	FDIC	26,014	25,657	3,605	13.9%	Yes	
29	9	29	2000	The Bank of Falkner	MS	BIF	FDIC	77,425	72,534	12,700	16.4%	Yes	
30	10	13	2000	The Bank of Honolulu	HI	BIF	FDIC	65,345	58,202	2,500	3.8%	Yes	
31	12	14	2000	National State Bank of Metropolis	IL	BIF	OCC	93,011	74,104	8,000	8.6%	Yes	
32	2	2	2001	First Alliance Bank Alliance B&T	NH	BIF	FDIC	18,400	17,500	119	0.6%	Yes	
33	5	3	2001	Malta National Bank	OH	BIF	OCC	9,500	8,800	80	0.8%	Yes	
34	7	27	2001	Superior Bank, FSB	IL	SAIF	OTS	1,765,455	1,606,214	750,000	42.5%		220,364
35	9	7	2001	Sinclair National Bank	AK	BIF	OCC	30,700	25,700	4,400	14.3%	Yes	
							Totals	5,097,739	4,525,318	2,056,524	40.3%		862,327

Note: A deposit insurance "fender-bender" is rather arbitrarily and liberally defined as (1) a failed institution with less than $50 million in assets and an insolvency loss percentage below 30%, (2) an institution with assets between $50 million and $100 million and a loss percentage below 20%, or an institution with more than $100 million in assets and an insolvency loss of less than $5 million.

Figure 1

BIF/SAIF Insolvency Losses Distributed by Loss Amount

35 Failures: 1995 to 10-12-01
$2.06 billion estimated cost

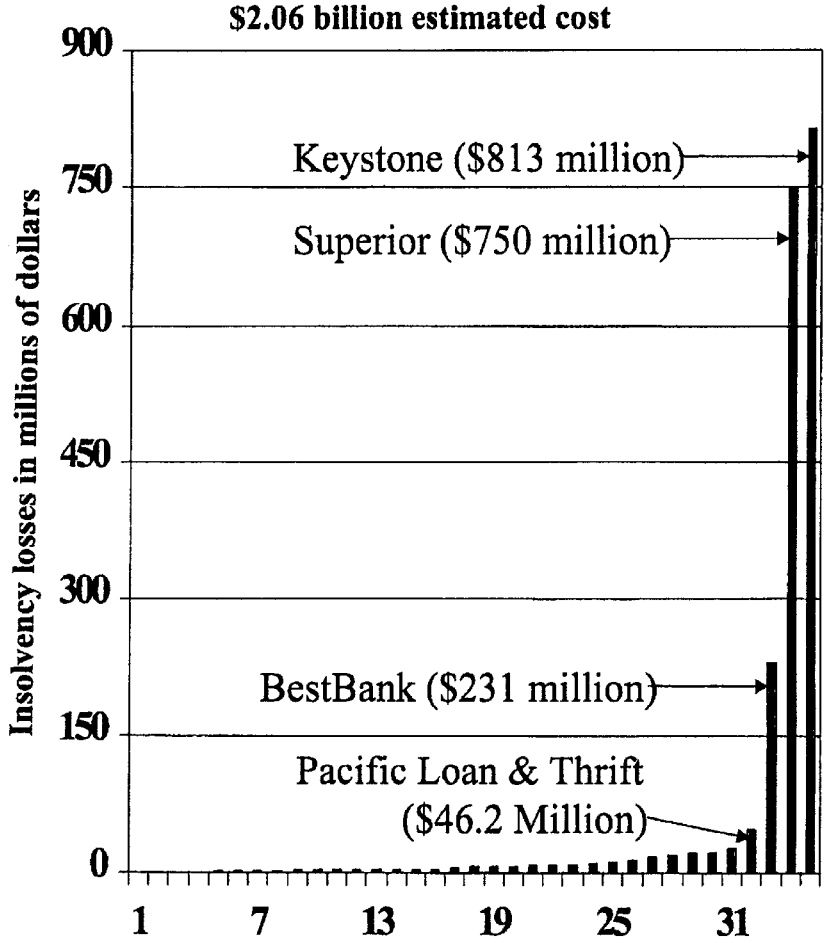


Figure 2

BIF/SAIF Insolvency Losses Stacked by Institution

35 Failures: 1995 to 10-12-01
$2.06billion estimated cost

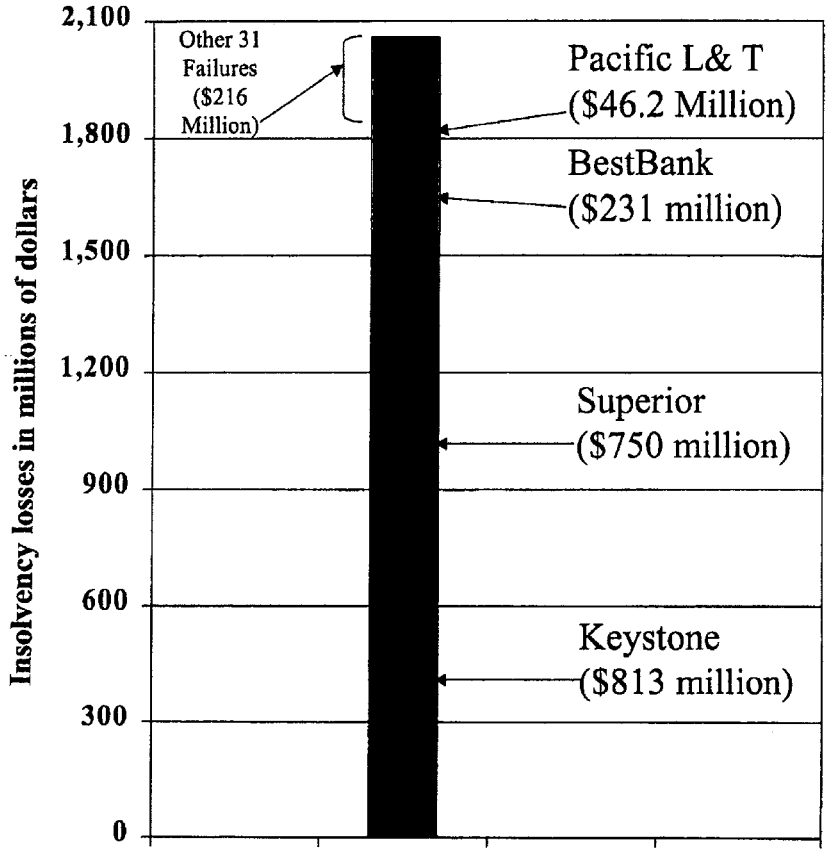


Figure 3

FDIC Insolvency Losses As a Percentage of Total Assets

35 Failures: 1995 to 10-12-01

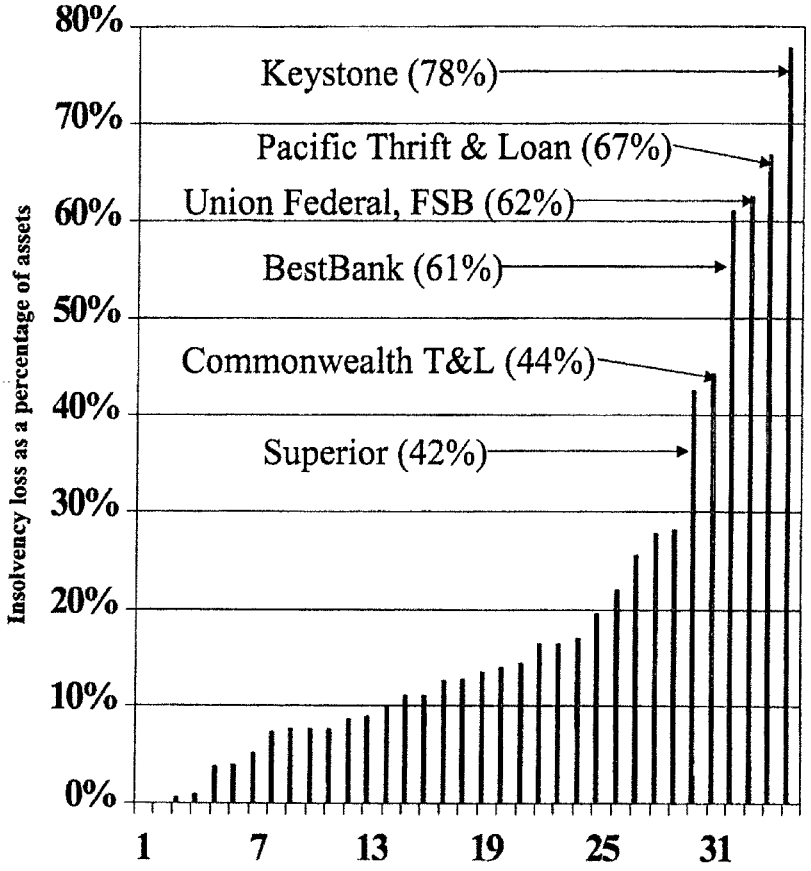
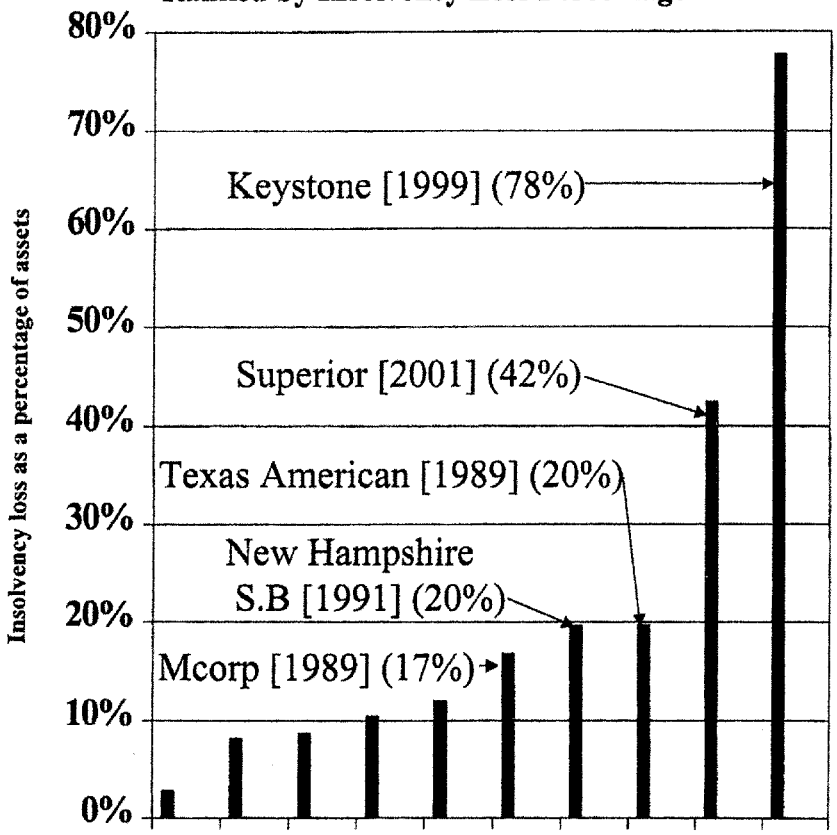


Figure 4

Ten Most Costly FDIC Bank Resolutions -- 1986-2001, Including Superior

Ranked by Insolvency Loss Percentage



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February 9, 2001

The Honorable Ellen S. Seidman
Director
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Re: Superior Bank, FSB; Oakbrook Terrace, Illinois

Dear Ellen:

I am writing to express my very deep concern about the solvency of Superior Bank, FSB, of Oakbrook Terrace, Illinois (OTS Docket Number 8566). While Superior appears to be quite well capitalized (tangible equity capital ratio of 13.5%), its substantial and growing proportion of assets with highly questionable values, reminiscent of the First National Bank of Keystone, strongly indicates that Superior in fact is deeply insolvent. Further, I question whether the Pritzker family will ride to Superior's rescue. Also, as the enclosed article from the February 5, 2001, issue of Chicago Business reports, Fitch has placed Superior on a long-term negative credit watch.

Enclosed are selected pages from the Sheshunoff call report data on Superior. I comment below on my principal concerns about Superior; other problems at this thrift also are quite evident, based on call report data and other information.

- Superior has three categories of assets ("Mortgage Derivative Securities," "Interest-Only Strip Receivables & Other Instruments," and "Advances for Loans Serviced by Others," as shown on pages 1 and 2 of the call report data) that constitute an increasing portion of Superior's balance sheet. Taken together, these three categories of assets rose from 36.7% of Superior's total assets at the end of 1997 to 43.7% at the end of 1999 and to 59.6% on September 30, 2000 (page 3). The book values for these assets are highly questionable. If the I-O Strips alone are worth only half of their book value, Superior would be insolvent on a book-value basis. Keystone, of course, taught that I-O strips arising from the securitization of low-quality loans are, at best, worth pennies on the dollar.

- Superior clearly has serious asset quality problems, with an extremely high level of loss provisioning. "Total Net Charge-Offs" for the first nine months of 2000 of $200.2 million (page 9) equaled 8.8% of Superior's assets at the beginning of 2000. Especially troubling was a $78.5 million reduction in "General Valuation Allowances" in the third quarter of 2000 that was not included in Total Net Charge-Offs, which left Superior with "Total Valuation Allowances" of just $12.2 million on September 30, 2000 (page 6). That amount is far too low given Superior's high risk lending, asset quality problems, and substantial "Balance of Assets Sold with Recourse Obligations" of $3.73 billion on September 30, 2000 (page 11). Properly establishing Superior's General Valuation Allowances would wipe out much, if not all, of Superior's Equity Capital.

- A troubling parallel with Keystone was Superior's reclassification of a substantial portion ($644 million, or 30% of Superior's total balance sheet) of Mortgage Derivatives as Interest-Only Strip Receivables as of March 31, 2000 (page 2). One can only wonder what other errors there are in Superior's call reports in light of this reclassification as well as the apparent underreporting of asset charge-offs discussed under the previous bullet.

- Although its reliance on "Broker Originated Deposits" has declined somewhat (page 13), Superior still relies too much on brokered deposits ($286 million at September 30, 2000). Also, Superior had far too much in uninsured deposits ($492 million at September 30, 2000) for an insolvent institution about to get a Fitch downgrade (page 13). That downgrade could trigger liquidity and funding problems at Superior.

- Superior's "Net Interest Income Before Provision for Losses" dropped dramatically during the first three quarters of 2000 (page 4). On an annualized basis, this income line was down 78% from 1999, which is quite serious given Superior's high level of losses on loans and other assets.

- Superior's "Other Noninterest Income" for the first nine months of 2000 was running at five times 1999's rate for that income item, which is highly suspicious given Superior's overall profitability problems.

- Superior's "Marketing and Other Professional Services" expense for the first three quarters of 2000 was running at double the pace of 1999, which in turn was up dramatically from earlier years. Perhaps this is why I am seeing so many Superior ads on CNBC.

I have identified other problems with Superior, but the points noted above should ring enough alarm bells at the OTS, if severe supervisory action against this institution is not already underway.

Because Superior is an FDIC-insured institution, I am forwarding a copy of this letter and its enclosures to the Donna Tanoue.

Please call if there is any aspect of Superior that you would like to discuss.

Very truly yours,

Bert Ely

cc: The Honorable Donna A. Tanoue, Chairman, Federal Deposit Insurance Corporation

Regulatory Moral Hazard

The Real Moral Hazard in Federal Deposit Insurance

BERT ELY

Many banking regulators, academics, and others hold that deposit insurance creates an undesirable moral hazard in banking. But the real moral hazard that federal deposit insurance creates is ***regulatory moral hazard.*** In this article I describe regulatory moral hazard, explain why depositor discipline of banks is highly undesirable, show how federal deposit insurance fosters regulatory moral hazard and propose a cross-guarantee concept for privatizing banking regulation so as to eliminate regulatory moral hazard in banking.

Moral Hazard

A moral hazard exists when a decision maker takes risks that he otherwise would not have taken, because the adverse consequences of the risk-taking have been transferred to a third party in a manner that is advantageous to the risk-taker and, more important, is disadvantageous and potentially even destructive to the party to whom the risk has been shifted. Insurance is such a risk-transferring device; therefore, the potential for moral hazard exists in any form of insurance, not just in deposit insurance. However, insurance presents a moral hazard only when it is underpriced or the insurance contract lacks sufficient safeguards for the insurer. A properly priced and carefully written insurance contract may actually cause an insured decision maker to take less risk or to be more conscious of the risks being taken than if he were uninsured. This

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desirable result occurs when the insurer assesses and then monitors the insured's risk-taking and sets risk-sensitive premiums designed to deter unwise risk-taking by the insured. Hence, for example, we expect an insured auto driver to drive more safely than an uninsured one: the insured driver fears losing his insurance if he drives carelessly; the uninsured one has no such concern.

Insurance enterprises have operated successfully for centuries, with relatively few failures, because they have used pricing and contractual safeguards to reduce insurance's moral hazard sufficiently to enable insurers to earn the profits needed to attract the capital to support the insurance risks that they have assumed. Deposit insurance has been a notable exception, especially in the United States. Over the last 165 years, most state-run deposit insurance schemes have failed, as did the Federal Savings and Loan Insurance Corporation (FSLIC). However, three successful state deposit-insurance plans operated in Ohio, Indiana, and Iowa prior to the Civil War (Calomiris 1989, 15–19). Those three plans are historical precursors to the cross-guarantee concept discussed in the last section of this article. The relatively few deposit insurance programs in other countries have, in general, not fared much better than those in the United States.

Deposit insurance's moral hazard is rooted in the very rationale of deposit insurance. Quite simply, deposit insurance exists only because bank failures have caused losses to depositors. If banks (used here as shorthand for depository institutions of all types) never failed or, more realistically, if banks failed with no losses to depositors, then no political demand for deposit insurance would arise. Like any other economic good, deposit insurance is demanded only because consumers feel a need for it. The United States has had a richer experience with deposit insurance primarily because it has had so many bank failures, especially in the twentieth century, compared to other industrialized countries.

To identify the root cause of the moral hazard in deposit insurance, we must first explore the underlying causes of bank failures. By definition, a bank fails when, in going out of business, it imposes losses on its creditors, primarily its depositors and, before the Civil War, the holders of its circulating notes (currency issued by state-chartered banks). A bank that liquidates itself or is acquired by another bank without imposing any loss on its creditors is not a failed bank for the purposes of this article, even though it may have been approaching insolvency.

Banks fail for three reasons. First, bad management (poor internal controls, self-dealing, bad lending and investment decisions, excessively rapid expansion, and so forth) is the main cause of isolated or noncontagious bank failures. Second, an economic contagion, almost always triggered by a decline in the market value of assets, causes many banks to fail that in normal economic times would not. Third, government restrictions on asset and geographical risk dispersion limit the ability of individual banks to diversify their asset risk in order to protect themselves against

contagious events such as a regional asset deflation made worse by asset fire sales. In effect, asset and branching restrictions magnify contagion losses by increasing the number of bank failures. Classic examples of such compounding are the enormousness of the U.S. banking crisis of the early 1930s, when branching was highly restricted, and the great number of banking failures in the 1980s in Texas and other states that barred or severely restricted branching. The banking problems of the 1980s were further exacerbated by federally tolerated state restrictions on interstate banking and branching.

Prevention of bank failures has been a public-policy concern for as long as governments have chartered banks, because banks, which hold money balances (checkable deposits) and the most liquid savings of individuals and businesses, have been viewed as fiduciaries. The banking function has been a public-policy concern also because banks collectively operate the non-coin-and-currency payments system. Accordingly, politicians have long recognized that it is politically undesirable for depositors and holders of circulating notes to suffer temporary illiquidity and outright losses associated with illiquid or failed banks. Consequently, bank charters almost always have imposed basic safety-and-soundness requirements on bank owners, such as minimum capital requirements, investment and asset restrictions and prohibitions, and liquidity or reserve requirements, intended to ensure sufficient bank liquidity and to prevent bank failures. Government safety-and-soundness requirements are roughly comparable to the "best practices" that would otherwise be specified for banks and other types of fiduciaries. Separately, governments have also used banks to obtain interest-free loans from the public through reserve requirements and government bond collateral requirements for bank-issued currency.

Although safety-and-soundness requirements have always been attached to bank charters, deposit insurance is largely a twentieth-century phenomenon. Governments impose safety-and-soundness or insolvency protection requirements on just a few types of businesses besides banks. Specifically, solvency requirements have been imposed on insurance companies and on securities brokers and dealers for the same reason: to prevent their failure, or at least to ensure that certain classes of creditors, such as those insured by insurance companies, and the customers of securities brokers and dealers, do not suffer losses due to insolvency or fraud. Hence, the sole purpose of bank safety-and-soundness regulation is to ensure that banks do not fail at a loss to their depositors and other general creditors.[1] Some might argue that banking regulation serves only to protect taxpayers against the consequences of failed banks. However, taxpayers are at risk when banks fail only to the extent that they are taxed to

1. In 1993, Congress added a "depositor preference" provision to the Federal Deposit Insurance Act (12 U.S.C. sec. 1821(d)(11)) which gives domestic depositors (insured and uninsured) a higher liquidation priority in a failed bank than other general creditors, including depositors in the failed bank's foreign branches.

protect depositors in failed banks against loss (witness the savings-and-loan debacle). In fact, banking regulation exists to protect depositors against loss so that taxpayers will not have to protect depositors against loss.

Because it is unrealistic to trust bank owners to comply at all times with safety-and-soundness requirements, governments have enforced these failure-prevention schemes through a bank inspection or examination program complemented by banking supervision. Government banking supervisors intervene, formally or informally, in the management of a bank to prevent its failure. (That branching and asset restrictions increase the likelihood of bank failures, thus compounding the problems that banking regulators must deal with, is a political contradiction that American lawmakers, state and federal, ignored until recent decades.) Therefore, unlike the failure of other businesses, bank failure reflects regulatory failure. There are different kinds of regulatory failure, including restricting branch banking, encouraging institutions to borrow short and lend long (which did in the savings-and-loans), failing to identify problems in banks, sweeping known problems under the rug ("regulatory forbearance"), and others.

It is both reasonable and desirable for depositors and other bank creditors to rely on regulators to prevent bank failures and thereby to protect the creditors from illiquidity and principal losses. Banking regulators act as government-designated agents to prevent bank failures. Creditor reliance on bank regulators is reasonable also because regulators make the rules governing banking activities and then use their legal authority to obtain unique access to private information about every bank, including each bank's books, records about specific assets, and personnel records (on a real-time basis, if necessary). They can then use this information to assess the condition of every bank that they have chartered. Further, banking supervisors have the legal authority to intervene in a wide variety of ways, such as by issuing a cease-and-desist order to prevent a troubled bank from failing or, if the conditions leading toward failure cannot be reversed in time, by forcing the bank into liquidation or a merger with another bank before it plunges into insolvency.

In other words, banking regulators have both access to information and tools of enforcement that depositors, other bank creditors, and even minority shareholders lack. Only those who actually control a bank are on a par with regulators, and even that is not always the case; an organization that monitors and supervises many banks can be expected to have a better understanding of external threats to bank solvency—such as a looming asset deflation—than many bank managers, who may hold parochial or distorted views of the commercial marketplace in which they operate. Hence, bank regulators are the best positioned of all parties, apart from (or perhaps even including) bank managers, to prevent bank failures that create insolvency losses.

Depositor Discipline Is Highly Undesirable

It is desirable for depositors and other creditors to rely on regulators to prevent bank failures also because this arrangement represents a classic division of labor. That is, a banking regulator, as a government-mandated agent for depositors and other bank creditors, stands in their shoes as a monitor of banks. From a societal perspective, to rely on creditors to prevent bank failures or to second-guess the regulators is less efficient than to demand that regulators perform competently by preventing bank failures. Therefore, relying on "depositor discipline" is less efficient than relying on "regulatory discipline," because depositor discipline is premised on the notion that if regulators fail to do the job for which they are being paid, depositors should do that job for them. Robert Litan and Jonathan Rauch candidly acknowledge the unreliability of regulatory discipline: "Markets tend to be less forgiving than regulators, who may be more willing to give a troubled institution time to work through its problems" (1997, 118). However, the only practical way depositors can discipline a troubled bank is by withdrawing their deposits. Sleepy regulators, though, will not wake up unless enough depositors run away to create a liquidity crisis at the bank, which in turn creates the potential for contagion and a systemic financial crisis.

One apparent proponent of this logic is Gary Stern (1997), the president of the Federal Reserve Bank of Minneapolis. He argues, in effect, that large depositors in a failed bank should suffer a loss if they are too slow to wake up a sleepy regulator:

> Congress [in] 1991 legislation tried to make bailouts less likely by giving regulators new tools to close a troubled bank before large losses develop. ***In practice, however, large, complex banks' financial fires are likely to burn for some time before regulators detect them.*** The answer? Uninsured depositors should not receive full protection when a too-big-to-fail bank is rescued. (emphasis added)

A financial crisis, or even the threat of a crisis, wastes real resources. Advocating bank runs to wake up regulators is comparable to urging someone with a malignant brain tumor to operate on himself or to be prepared to intervene in his brain surgery if the surgeon starts to bungle the job. Perhaps a better analogy is the passenger on an airplane. Should passengers, who have no access to the airplane cockpit or the air traffic control system, nonetheless be held even partially responsible if the airplane in which they are riding crashes? The argument for depositor discipline raises this intriguing question: If depositors are fully capable of judging a bank's condition, why are banking regulators needed at all?

Mistakes will happen, though, and some banks will fail despite being closely regulated, just as even a highly competent surgeon will occasionally lose a patient on the operating table. In most businesses today, malpractice and product-liability

lawsuits as well as product and service warranties (which are insurance by another name) protect consumers from product and service defects. Banking regulation too is a business enterprise, because it provides a service—failure protection—that its customers (banks) pay for through examination fees. Therefore, it is only fair that bank creditors, who ultimately bear the cost of those fees, should be protected against regulatory failure, just as consumers increasingly are compensated, through lawsuits and payments under product warranties, for damages caused by incompetent professionals and defective products. In effect, because regulators are governmentally designated agents for depositors and other bank creditors, they must be liable for their errors, just as surgeons must be liable for their negligence.

Holding the government liable for its regulatory errors is not a completely foreign concept. In 1997 the federal government agreed to pay $25 million toward settlements that US Airways reached with survivors and victims' families after a 1994 crash because air traffic controllers, who are federal employees, contributed to causing the crash (Bloomberg News 1997). Notice that in this as well as in other airline crashes, no responsibility for the crash was attributed to the plane's passengers or their family members.

Bank regulators, as persons, and the government, as the owner and operator of the bank-regulation enterprise, traditionally have been exempt from malpractice lawsuits because of their "sovereign immunity"—the king can do no wrong. That notion reeks of self-interest. Instead, based on the product-liability analogy, if the government—and by extension the taxpayers—wants to conduct a bank-regulation business, it ought to assume the risks associated with that business, specifically, it ought to be liable to depositors for regulatory error, regardless of the cause or magnitude of the resulting bank failures. Because governments are loath to abandon sovereign immunity, a product warranty, in lieu of lawsuits against the government, is needed to protect depositors against losses in failed banks. Deposit insurance is that product warranty. That is, deposit insurance exists to protect depositors from regulatory error and incompetency, just as product warranties substitute for product-liability lawsuits in protecting, for example, car buyers from manufacturing flaws.[2]

But deposit insurance is not a free lunch; someone must pay for it. Although general tax revenues could be used to pay for regulatory error, within limits, it is much safer politically for elected officials to tax surviving banks to protect depositors and other bank creditors from regulatory failure. Banks do not generate much political sympathy, even though they pass on to their depositors, in the form of lower interest rates, the deposit insurance tax levied on them. Although called a premium, this levy in fact is a tax when the deposit insurance scheme is a government monopoly in which

2. Although federal deposit insurance was enacted as much to preserve unit banking as to protect small depositors, deposit insurance very effectively protected one form of bad regulation—branching restrictions—that is only now disappearing.

bank participation is mandatory. The FDIC is such a monopoly. Attempting to make FDIC premiums risk sensitive does not alter the fact that they are a tax to the extent that they are not truly risk sensitive—and in fact they are not.

Federal Deposit Insurance Fosters Regulatory Moral Hazard

Federal deposit insurance fosters regulatory moral hazard, or regulatory slackness, because the deposit insurance tax shifts the cost of regulatory error from depositors and taxpayers to the nation's surviving banks, which politically are less able than depositors and taxpayers to avoid paying the losses arising from bank failures. Consequently, because of the relatively small pain that the deposit insurance tax causes banks, up to a certain point regulators can afford to be less diligent than they would be if depositors or taxpayers in general paid for bank-insolvency losses. In this circumstance and in the absence of a banking crisis, regulatory diligence declines. In effect, it is the relative political ease of taxing surviving banks to cover bank-insolvency losses that arise from regulatory error that creates regulatory moral hazard.

Banks generally do not resist bearing the costs of regulatory failures that are imposed on them—in the form of both deposit insurance premiums and costly regulatory safeguards—if the risk-spreading benefits of deposit insurance, specifically the ability to operate with higher leverage (Ely 1997), significantly exceed the cost of regulatory failures. However, regulatory moral hazard consumes much of the benefit that deposit insurance, as insurance, conveys to banks, as evidenced by the banks' substantial loss of market share, in terms of assets held on-balance-sheet, to less regulated financial intermediaries such as mutual funds. By one estimate, banking's market share has dropped by half since the end of World War II (Kroszner 1999, 3). Mispriced deposit insurance and one-size-must-fit-all regulation increasingly create a substantial cross subsidy that flows from well-run to badly run banks. This cross subsidy arises because well-run banks are overcharged for their deposit insurance and, worse, are subject to excessive safety-and-soundness requirements, whereas badly run banks are undercharged for their deposit insurance and may be subject to insufficient safety-and-soundness requirements (Ely 1999a, 13–15). Even less onerous regulatory treatment for "well-capitalized" banks does not overcome the crudeness of one-size-must-fit-all government regulation and risk-*insensitive* pricing of deposit insurance.

The increased regulatory laxity fostered or subsidized by the deposit insurance tax represents the true moral hazard of deposit insurance. Worse, the federal deposit-insurance tax subsidizes regulatory laxity in all its forms: the incompetency and lack of accountability of regulatory officials; branching restrictions; and unwise but government-encouraged policies such as borrow short, lend long and the excessively risky lending prompted by the Community Reinvestment Act. Understandably, then, rational regulators would oppose any effort to increase depositor discipline on banks,

because the inevitable losses suffered by depositors who do not run fast enough from failing banks will create political pain for elected officials. Rational bankers also would oppose depositor discipline because the failure-protection safeguards that politicians will impose on banks that are explicitly subject to depositor discipline will be much more costly than the safeguards needed in a sound deposit insurance program.

Regulatory laxity can become excessive, though, as it did in the years leading up to the savings-and-loan crisis and as it almost did prior to the commercial banking problems of the late 1980s and early 1990s. Excessive laxity creates a situation in which the surviving institutions simply cannot pay, or can successfully resist paying, for the entire cost of regulatory failure. At that point the general taxpayers are tapped, usually by mortgaging future tax collections through government bond sales that raise sufficient cash to protect depositors and other creditors of failed banks. The funding of the U.S. savings-and-loan cleanup, the French government's multibillion-dollar bailout of Credit Lyonnais, and the bank bailout costs now hitting taxpayers in Japan and other Asian countries are excellent examples of the tax consequences of excessive regulatory laxity.

Regulatory moral hazard is costly even in benign economic times, and almost certainly its cost will rise in future years, for three reasons. First, there is the cost of the occasional bank failure. Second, and much more significant when few banks are failing (as at present in the United States), are regulatory compliance costs, specifically safety-and-soundness requirements, that politicians impose on banks to prevent excessive regulatory laxity. Third, the costs associated with regulations designed to curb regulatory laxity prompt creative people to engage in regulatory arbitrage by constructing lightly regulated channels of financial intermediation, such as money-market mutual funds, asset securitization, and hedge funds, that seemingly pose no risk of loss to creditors or taxpayers. The near collapse of Long Term Capital Management (LTCM) in the late summer of 1998 is an excellent example of regulatory arbitraging gone sour. In effect, regulatory arbitragers find it profitable to expend real resources to lawfully sidestep efficiency-impairing regulations. The growth of regulatory arbitrage may be a key reason why the financial sector of the U.S. economy has doubled its percentage share of the GDP over the last 50 years.

Electronic technology is raising the cost of containing regulatory moral hazard by destroying the efficacy of traditional banking regulation. New technology is making government's one-size-must-fit-all regulation increasingly unworkable, and therefore inefficient, as it facilitates regulatory arbitrage. Elected officials respond to this arbitraging by imposing additional costly regulatory burdens on the parties they can still ensnare in their regulatory net.

Numerous banking observers have implicitly, if not explicitly, recognized the problem of regulatory failure, but they have dealt with the problem by developing devices for sidestepping rather than eliminating it. They seek to fix the old jalopy rather than buy a new car. For example, Edward Kane (1997) has observed that

"regulators around the world energetically resist accountability," and he has considered "what kinds of regulatory schemes and truth-telling requirements might be used to improve accountability for regulatory performance" (147). Matthew Billett, Jon Garfinkel, and Edward O'Neal (1998) have observed that "the current regulatory structure may undermine the effectiveness of market discipline in deterring bank risk-taking. Moreover, the effectiveness of market discipline declines as a bank becomes more risky because riskier banks use more [government] insured deposits" (355). Many other commentators on banking regulation acknowledge at least by implication the inherent shortcomings of government banking regulation.

Proposals to remedy regulatory shortcomings generally reflect one of two approaches: reduce the riskiness of banks or increase the market discipline over banks to compensate for ineffective government regulation. The first approach often includes the "narrow bank" proposal for limiting a bank's assets to government debt or high-quality, short-term commercial paper. Litan (1987) presents the classic prescription for a narrow bank. However, the narrow-bank scheme merely shifts the potential for systemic instability, and the taxpayer bailout it may necessitate, to nonbank financial firms, as the LTCM fiasco demonstrated.

Requiring banks to sell more subordinated debt is another nostrum that has been offered to compensate for the shortcomings, or worse, of government regulators. Under this proposal the financial marketplace would signal to the regulators that a bank was weak if the yield on the bank's subordinated debt amounted to more than a specified percentage above the yield on U.S. Treasury debt of a comparable maturity, or if the bank could not keep enough subordinated debt outstanding because the markets refused to buy the debt at any price or kept "putting" it back to the bank, that is, seeking repayment at will. Joseph Haubrich (1998), an advocate of puttable subordinated debt, observes that some proposals, presumably including his own, "take important actions out of the regulators' hands. . . . The puttable debt drags the bank (and the regulators) into the public eye and thus increases accountability"(63). Charles Calomiris (1999), a vigorous advocate of subordinate debt discipline for regulators, recently observed that "government supervision and regulation, without any external market-derived pressure, are bound to fail" (34). But that statement begs the question, Why have government banking regulation in the first place?

Eliminating Regulatory Moral Hazard

Any attempt to eliminate regulatory moral hazard must first recognize that raising the standard of living is a major public-policy goal in the United States and most other countries. A key to boosting living standards is eliminating public policies that impose inefficiencies on business enterprises, including banks. Permitting the commercial marketplace to minimize moral hazards is one way to improve business efficiency. Essential to minimizing moral hazard is ensuring that the decision maker who causes a

moral hazard will bear the full cost of whatever hazards that decision maker has created. This notion, inherent in any form of privately provided insurance, can be applied to banking and deposit insurance.

Because banking regulation today is universally a government monopoly, only the political marketplace can limit the cost of regulatory failures. In effect, banking regulators do not benefit from the competitive pressures of the commercial marketplace that would force them to operate efficiently and to properly price their product, which is loss prevention. Proper pricing of a product, especially insurance, is essential for optimizing its usage.

Properly priced deposit insurance, that is, risk-sensitive premiums based on *leading* indicators of banking risk,[3] would eliminate the moral hazard commonly associated with deposit insurance because risk-sensitive premiums would induce banks to become better risk-takers, which in turn would optimize bank risk-taking for the entire economy. Properly priced deposit insurance would minimize regulatory moral hazard and the cross subsidy that it produces within the banking industry. However, a government monopoly can never properly price deposit insurance, because accurate pricing occurs only in private, competitive markets. Competing private regulators would not be able to get away with regulatory laxity, because well-run banks would seek to be regulated by more efficient regulators who charged premiums and imposed safety-and-soundness requirements that did *not* subsidize badly run banks. In effect, regulatory moral hazard exists today because federal deposit insurance and the regulations that accompany it are not subject to the forces of the commercial marketplace.

Proper pricing would also make a bank more sensitive to its own risk-taking than it would be if it operated without deposit insurance, because deposit insurance pricing, as opposed to changes in the bank's stock price, can reflect a bank's risk-taking more accurately and in a more timely manner. The highly leveraged nature of banking, which deposit insurance enhances, makes banks even more sensitive to their risk-taking. As with any other product or service, though, insurance (of any kind) can be properly priced only in a private, competitive marketplace. Hence, elimination of the regulatory moral hazard in deposit insurance requires that the business of banking regulation be privatized so that both bank regulation and deposit insurance can benefit from the forces of competition. The political marketplace ought to delegate to a properly structured commercial marketplace the responsibility for ensuring the sound operation of individual banks. Like many other activities, *ensuring the safe and sound operation of individual banks has become too important to the overall health of the economy to be left to government.*

3. Leading indicators of risk specific to a bank include internal control deficiencies, risk mismatches, and excessively heavy asset concentrations. The key external leading indicator of banking risk is a bank's credit exposure to an asset bubble.

The Cross-Guarantee Concept for Privatizing Banking Regulation

The "cross-guarantee" scheme (Petri and Ely 1995) represents one way, perhaps the only way, to successfully privatize banking regulation and deposit insurance. In a world of cross-guarantees, instead of being subject to government safety-and-soundness regulation and supervision, banks would contract for such regulation and its attendant product warranty. In effect, the cross-guarantee plan substitutes negotiated contractual regulation for one-size-must-fit-all government regulation. Contractual regulation is *not* deregulation or self-regulation. Instead, it represents a shift of the regulatory function from the government to the private sector by means of contracts tailored through negotiations to the circumstances of individual banks.

Specifically, each bank would negotiate with an ad hoc syndicate of voluntary guarantors (largely other banks) the prudent banking practices that the bank agrees to follow. The guarantors would select one of several competing private firms, called syndicate agents, to monitor the bank's compliance with the terms of its cross-guarantee contract; in effect, syndicate agents would replace government bank examiners and supervisors. The contract would also guarantee all deposits and almost all other liabilities of the bank against loss should the bank become insolvent. That guarantee would effectively serve as the contract's product warranty, thereby meeting the public-policy objective that banking regulation protect depositors and other bank creditors against bank insolvency losses. That protection would also produce another highly desired public good: a stable financial system (Ely 1999b). The guaranteed bank would pay a negotiated, risk-sensitive premium to its guarantors for providing their guarantee. A portion of the premium would be paid to the syndicate agent as a contract monitoring fee; the balance would compensate guarantors for the insolvency risk they assume on behalf of the bank's depositors and other guaranteed creditors.

The cross-guarantee concept has been incorporated into a comprehensive legislative proposal. H.R. 4318, a bill introduced by Representative Tom Petri in the U.S. House of Representatives on September 28, 1996, would utilize marketplace competition in three ways to improve the efficiency of banking regulation while minimizing moral hazard:

- Negotiating the prudent banking practices to which it will adhere would permit a bank to tailor those practices to its business strategy, but in a manner that minimizes its guarantors' risks. Today, one-size-must-fit-all banking regulation forces banks to follow herd-like and therefore suboptimal business strategies that periodically cause financial crises.
- Banks and their guarantors would negotiate premium-pricing formulas based on *leading* indicators of banking risk. The FDIC's risk-sensitive premiums are, for

political reasons, based on lagging measures of banking risk. This political reality was dramatically illustrated in early 1999, when the FDIC announced that it intended to raise the deposit insurance premium rate for well-capitalized banks with so-so managements (Barancik 1999a). Because of negative political reaction, the FDIC quickly backed away from that proposal (Barancik 1999b). In effect, cross-guarantee premiums would encourage a bank to incorporate in the interest rates that it charges the impact a particular risk is expected to have on its cross-guarantee premium. More accurate pricing of bank credit would lead in turn to more efficient use of that credit, which is highly desirable from a societal perspective.

- Because syndicate agents would compete for business on a contract-by-contract basis, they would have to monitor banking risks efficiently without alienating the banks they monitored or causing significant losses for guarantors. The competitive pressure on syndicate agents would be so severe that a major preventable loss to the guarantors of a failed bank could cause its syndicate agent to be fired as the monitor of other cross-guarantee contracts; a Barings- or Daiwa-type monitoring failure might even drive the syndicate agent for the failed bank out of business. One of the many failings of government banking regulation is that the regulators rarely suffer personally for insolvency losses among their charges.

In sum, the cross-guarantee proposal allows numerous constructive marketplace tensions to foster better banking regulation.

Further, the federal government would ensure that each cross-guarantee contract complied with explicit risk-dispersion rules designed solely to ensure that all losses incurred by guarantors in protecting the creditors of failed institutions remain entirely within the universe of guarantors, even in economic conditions far worse than the Great Depression. Preventing the failure of individual institutions would be the exclusive responsibility of guarantors and their syndicate agents. There are four risk-dispersion rules: (1) every guarantor must be guaranteed by a syndicate of other guarantors, thereby creating an interlocking web of guarantors; (2) each contract must have a minimum number of guarantors, no one of which can assume more than a specified amount of risk under the contract; (3) individual guarantors must be limited in the amount of risk they can assume under any one contract and in the aggregate; and (4) all guarantors must be subject to a uniform stop-loss rule that will spread all of a guarantor's losses beyond a certain level to its own guarantors and, if necessary, to additional levels of guarantors.[4]

4. Numerous articles and papers about cross-guarantees, as well as the Petri legislation, have been posted at http://www.ely-co.com.

Conclusion

Improvements in electronic technology increasingly reveal the inherent weaknesses of government banking regulation. The political marketplace has responded with even heavier regulation of those it can most easily regulate, specifically banks, while developing mechanisms that ensure, as a practical matter, that surviving banks and not the general taxpayer will pay for future deposit insurance losses. But this regulatory product warranty has become increasingly expensive for banks, thereby distorting the financial intermediation process by increasing the incentives for regulatory arbitrage. In effect, federal deposit insurance has augmented the societal cost of regulatory moral hazard. Only through the use of market mechanisms can regulatory moral hazard be eliminated. The cross-guarantee proposal represents one way, perhaps the only way, to apply market processes to eliminating regulatory moral hazard—the real moral hazard in federal deposit insurance.

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Industry, Not Government, Is the Real Deposit Insurer

■ BY PETER J. WALLISON

It is not well known, even in the banking industry, that the federal government no longer stands behind what are generally called "insured deposits."

Since the Federal Deposit Insurance Corporation Improvement Act was adopted in 1991, it is the capital of the banking industry as a whole that backs up the promise to depositors that their savings are good.

Although the FDIC sticker is still on the door and Congress has passed resolutions that contain comforting language, in reality the federal government has no obligation to step in until the banking industry's capital has been exhausted. Even then it is doubtful that the full faith and credit of the United States have been effectively placed behind what are still called insured deposits.

This is true because the FDIC Improvement Act set up a system in which the FDIC has the authority, in effect, to levy taxes on the banking system — in proportion to the deposits in each bank — whenever the Bank Insurance Fund falls below 1.25% of total deposits. And if the FDIC believes that the condition of the industry is such that the fund could suffer substantial losses quickly, it has the authority to require additional premiums to provide a cushion against a large future claim.

The act even contemplates that a major loss or series of losses will exhaust the FDIC's fund too quickly for the banking industry to replenish it. In this case the law authorizes the FDIC to borrow up to $30 billion from the Treasury to meet its obligations, until it can collect the additional necessary premiums. Those would be used to rebuild the fund to at least the 1.25% level and to repay the Treasury.

What is unusual about this system is that the banks have no means of limiting their losses in advance, and that the FDIC has lost its incentive to limit losses. Before the FDIC Improvement Act, the agency did have an incentive: The size of its fund was limited, and if seriously impaired could be replenished only through many years of fixed annual assessments.

Once the FDIC acquired the authority to levy fees on the banking industry for immediate replenishment, this incentive disappeared.

A separation between those who bear losses and those responsible for preventing losses does not seem to be sound public policy. It is also a bit ironic, since the FDIC was established because of the moral hazard associated with deposit insurance. Now it appears that the FDIC, insulated from losses associated with its own administration, could be a source of moral hazard itself.

One way to address this problem is to change the deposit insurance system so that the banking industry establishes the loss-reduction policies that the FDIC enforces — especially those concerning bank examinations and insurance premiums. Through a properly administered system of risk-based premiums, backed up by a more comprehensive (and costly) program of examinations, strong and well-managed banks should be able to reduce the risks they face from weak and badly managed institutions. The additional costs of examinations would be more than offset by the prevention of losses from failures and bailouts.

Under such a plan the FDIC would remain the stakeholder for the insurance fund and the general manager of the system. The sticker would remain on the door. But the FDIC would levy and collect risk-based premiums, enforce rules and regulations, and employ examiners — all under policies established by the banking industry. An objection to this system is that it could clear the way for anticompetitive behavior or discrimination, especially in cases of competition between large and small banks. This is of course a possibility, but the legislation necessary to establish such a system would forbid and penalize anticompetitive behavior and would be enforced by the FDIC as administrator and arbiter.

There is in fact a good example of a self-regulatory system in which the industry has a large number of direct competitors of different sizes. The National Association of Securities Dealers, under the supervision of the Securities and Exchange Commission, enforces the fair-trading practice rules that are applicable to securities firms. Although the securities industry is as varied and differentiated as the banking industry, large and small firms have operated in this structure satisfactorily for more than 60 years.

After the savings and loan debacle of the late 1980s and the almost equally serious losses in the banking industry at that time, we should have learned that it is imprudent to allow some institutions to take risks while leaving those that will ultimately bear the losses without the means to control or prevent them. The good economic conditions that have prevailed since the FDIC Improvement Act was adopted should not obscure the fact that all well-managed banks — large and small — have a major stake in preventing future losses by the Bank Insurance Fund.

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Mr. Chairman, it is a pleasure to testify before this Committee on the public policy implications and lessons from the recent failure of the ironically named Superior Bank, located in the suburbs of my home city of Chicago. What is important is not so much that Superior failed—bank failures have been infrequent in recent years and inefficient or unlucky banks should be permitted to exit the industry in order to maximize the industry's contribution to the economy—but the exceedingly large magnitude of its loss to the FDIC. This loss has been estimated in the press to be somewhere between $500 million and $1 billion, or 20 to 45 percent of the bank's assets at the date of its resolution. Recent changes in the Federal deposit insurance system have greatly reduced the Government and taxpayer's liability for losses to the FDIC from bank failures by requiring near automatic and near immediate increases in insurance premiums to replenish the fund whenever the FDIC's reserves fall below 1.25 percent of insured deposits. In this way, the system is effectively privately funded.[1] Nonetheless, because bank failures are widely perceived to be more disruptive than the failure of most other firms, and the larger the loss (negative net worth), the greater the potential for disruption, bank failures are still a public concern and an important public policy issue.

In response to the large number of bank and S&L failures in the 1980's and early 1990's at a high cost not only to the surviving institutions but, at the time, also to taxpayers, Congress enacted the FDIC Improvement Act (FDICIA) in 1991 to reduce both the number and, in particular, the cost of bank failures through Prompt Corrective Action (PCA) and Least Cost Resolution (LCR) by the regulators.

PCA specifies sanctions that first may and then must be imposed by the regulators as a bank's financial condition deteriorates in order to turn the bank around before it becomes insolvent with possible losses to the FDIC. The sanctions are triggered primarily by declines in bank capital ratios. But PCA is intended to compliment, not to replace, the regulators' other supervisory techniques that rely on other signals of a bank's financial condition. Indeed, PCA was introduced not because regulators tended to react too quickly to developing bank problems, but too slowly (to forbear).[2] Thus, regulators are not required or even encouraged to delay corrective action until the capital tripwires are breached.

Because of confidentiality, I do not know with certainty many of the details of the Superior failure and, in particular, the roles of the OTS and FDIC. However, the public information available casts suspicion on both the promptness of the OTS's actions and the strength of the corrective actions when taken. Nor is a 20 to 45 percent loss rate what the drafters of FDICIA or, I suspect, Congress had in mind when they designed LCR. Indeed, this loss rate promises to be greater than the average loss rate on banks of comparable size in the bad pre-FDICIA days.[3] [4]

To put the Superior failure in perspective, while it is the largest FDIC insured institution to fail since mid-1993, it is a relatively small bank. Its losses, large as they may be, are no threat to either the FDIC or the local or national economies. Moreover, the loss rate for the next two largest institutions that failed in this period were even greater. The estimated loss rate on the 1999 failure of the $1.1 billion First National Bank of Keystone (West Virginia) is near 75 percent and that on the 1998 failure of the $320 million, again ironically named, BestBank (Boulder, Colorado) is near 55 percent (see attached tables). This suggests that something is not working the way it was intended. Although all three of these banks may be viewed as outliers and not representative in their operations of the large majority of

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[1] George G. Kaufman, "The Current Status of Deposit Insurance in the United States and Proposals for Reform," Working Paper, Loyola University Chicago, August 2001; George G. Kaufman, "Congress Should Not Monkey With Deposit Insurance System," *American Banker,* August 10, 2001, p. 6; and George G. Kaufman and Peter J. Wallison, "The New Safety Net," *Regulation,* Summer 2001, pp. 28–35.

[2] George J. Benston and George G. Kaufman, "The Intellectual History of the Federal Deposit Insurance Corporation Improvement Act of 1991" in George G. Kaufman, ed., *Reforming Financial Institutions and Markets in the United States*, Boston: Kluwer Publishers, 1994, pp. 1–17.

[3] George G. Kaufman, "The U.S. Banking Debacle of the 1980's: Overview and Lessons," *The Financier*, May 1995, pp. 9–26.

[4] The high resolution costs should also serve as a wake-up call for all insured banks that, because they will pick up the cost in the form of higher premiums when the FDIC's reserve ratio dips below 1.25 percent, they need to monitor more carefully and continuously both their fellow banks to discourage excessive risk-taking and the regulatory agencies to encourage more timely resolutions.

banks—BestBank was primarily an Internet bank, Keystone relied to a unduly large extent on insured brokered deposits to fund very risky mortgage residuals, and Superior focused on transforming its high credit risk subprime mortgage loans into even higher credit and interest risk interest only residuals—one has to wonder, if the supervisors cannot do better when times are good and failures few, how would they do, if things are not changed, when times are bad and bank failures more frequent. On the other hand, it may be argued that, at such times, bank problems are likely to be more generic and supervisors more able to deal with them. Nevertheless, an important contribution of these hearings is to identify lessons from the recent costly failures that may reduce the probabilities of a repeat performance.

It appears that in Superior, and possibly even more so in the other two failures, a number of red flags were flying high that should have triggered either a rapid response by regulators or continuing careful scrutiny. Although each flag was not flying for each bank, these red flags would include, but not be limited to:

- Very rapid asset growth. Superior doubled in size in the 3 years between year-end 1996 and 1999 and Keystone grew even more rapidly.
- Well above market rates offered on insured and/or uninsured counter or brokered deposits. Had the regulators sent their examiners to the dozen banks and thrifts that offered the highest deposit rates (which are readily available from private vendors) in the late 1980's, they would have zeroed in on the worst failures of that period.
- Rapid withdrawal (run) of uninsured deposits. This suggests that the market is indicating concern that the bank is in financial difficulties and finds it cheaper to fund itself with other sources of funds, such as insured deposits.
- High ratio of bank repurchase agreements to total funding. This indicates that other banks, which may reasonably be expected to be well informed, are lending only on a collateralized basis.
- High percentage of brokered deposits.
- A large percentage of activity in risky lending. Although legitimate and, at times, highly profitable, subprime lending is generally riskier than prime lending and requires more careful supervision by both the bank's own management and the regulators. As the FDIC has noted, while largely subprime lending institutions account for less than 2 percent of the nearly 10,000 insured institutions, they account for some 20 percent of all problem institutions.
- Very large percentage of assets in not only very risky but also complex derivatives and other nontraditional assets, given the bank size and management capabilities. Derivatives, per se, are not risky if used appropriately by knowledgeable management. Many banks use derivatives successfully to reduce portfolio risk exposure.[5] But heavy use of the most risky and complex derivatives by smaller banks bodes ill and deserves greater regulatory oversight.
- High percentage of off balance sheet recourse obligations relative to on balance sheet assets.

None of these flags, either by itself or even in combination with others, guarantees trouble. But because the cost of spotting them is low, they are worth following up on to see whether the fish really smells.

We would know a great deal more about what the regulators did or did not do and who knew what when with respect to these flags in Superior, if we knew:

- The dates of the recent on-site examinations by the OTS.
- What was discovered in these exams.
- What corrective actions were taken and when.
- What actions were taken by Superior in response to these suggestions and recommendations.
- What did the FDIC believe it knew in 1999 that the OTS may not have known.

As noted earlier, the available public evidence suggests either very late realization of the seriousness of the situation by the OTS, not very forceful corrective actions by the OTS, and/or not very rapid nor strong response by Superior. Moreover, the speed of regulatory action was particularly slow after Superior's reported equity capital ratio on call reports at year-end 2000 declined below the 2 percent threshold for critically undercapitalized status that triggers receivership, conservatorship, or a recapitalization plan within 90 days.

A number of additional questions arise. In retrospect it is clear that Superior's reported capital was overstated by, among other things, underreserving for loan losses well before year-end 2000 and even before the reevaluation of the "toxic

[5] Elijah Brewer, William Jackson, and James Moser, "The Value of Using Interest Rate Derivatives to Manage Risk at U.S. Banking Organizations," *Economic Perspectives* (Federal Reserve Bank of Chicago), Third Quarter 2001, pp. 49–66.

waste" residuals. Why were adjustments not made earlier? Why did the FDIC sign off on the proposed recapitalization plan at the end of the 90 day period, when the negative net worth at that time was likely to be much larger than the reported proposed recapitalization amount? Hopefully, we will know more about these events after these hearings than we knew before them and we can develop more refined and accurate prescriptions for future regulatory action. But based on the public information to date, I recommend the following proposals for serious consideration:

- Increase regulatory emphasis on red flags and quicker responses.
- Establish an interagency SWAT team for valuing complex assets.[6] This would likely be of particular benefit to the OTS and FDIC, who deal primarily with smaller and less complex institutions. Making it an interagency team would reduce turf considerations in calling on it for help.
- Increase the values of the capital ratios for the tripwires in PCA. As I have argued for many years now, the current values were determined by the regulators when banks were in weak financial condition in 1992 and are less appropriate today when the capital ratios of almost all banks exceed the regulatory guidelines in each category and are low relative to those of bank competitors not covered by the Federal safety net. For example, the FDIC notes that the average equity ratio for banks concentrating in subprime lending was about 10 percent, less than one-half that of their nonbank competitors.
- Put the examination fee structures of the OCC and OTS on the same basis as those of the FDIC and the Federal Reserve. By needing to charge fees for examinations to obtain their operating revenue, there is a tendency for the OCC and OTS to view their member institutions as "clientele" and to be reluctant to take actions that may encourage them to change their charter and primary regulator. While supervisors and banks should not be in an adversarial position, neither should regulators view banks as their clientele. A possible solution is to have all examinations financed by the FDIC through insurance premiums.
- Shorten the period for beginning the resolution process after a bank is classified critically undercapitalized to 90 days, with no extensions. The evidence is strong that losses to the FDIC increase on average the longer an insolvent or near insolvent bank is permitted to continue to operate.[7]
- Increase the ability of the FDIC to participate in on-site examinations by other agencies. However, this may not be easy to achieve in practice. On the one hand, too many FDIC examinations would involve duplication and inefficiency. On the other hand, because FDIC participation examinations cannot be hidden from view, sporadic FDIC participation with other primary Federal regulators may send a signal that could start or reinforce an unwarranted run. One way may be to have the FDIC participate in the examination of all "3", "4", and "5"—CAMELS rated banks and of "1" and "2"—rated banks on a random basis.
- Increase emphasis on market valuations, particularly for equity of large banks. Although FDICIA encouraged this, it has received a cold shoulder from regulators.
- Require a minimum of credibly, uninsured, subordinated debt, particularly for large banks, that can count fully as regulatory capital to provide supplementary market signals of the bank's financial strength from either primary or secondary markets and to trigger regulatory response as part of or in addition to PCA.[8]

But none of these suggestions will be effective unless the supervisors have not only the ability but also the will to comply fully with the underlying objectives and spirit of PCA and LCR. At times, the actions of all four Federal bank regulatory agencies suggest a lack of commitment. It may be desirable, therefore, to encourage additional sensitivity training for regulators to increase their commitment to these important objectives. Regulators should be judged adversely not by the number of bank failures, but by the cost of the failures.

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[6] Superior's interest only residuals and some other assets appear to have been so difficult to value that the FDIC did not advance a dividend to the uninsured depositors of the present value of the estimated recovery amount of the assets as it does in most failures. This increased the hardship to these depositors by having their accounts in excess of $100,000 frozen until recovery is actually achieved.

[7] Some regulators were recently quoted in the *American Banker* that they had nursed a number of "4" and "5"—CAMELS rated banks back to health at a cost saving to the FDIC. If, as appears likely, some of these banks had also been classified critically—undercapitalized, history clearly documents that greater cost savings are achieved, on average, through quicker resolution. Rob Blackwell, "Debate on Exam Power is Headed for Congress," *American Banker,* September 4, 2001, pp. 1, 6.

[8] U.S. Shadow Financial Regulatory Committee, *Reforming Bank Capital Regulation,* Washington, DC, American Enterprise Institute, 2000.

FDIC Resolutions of BIF Insured Banks
and SAIF Thrift Insured Institutions (a)
1986 - 2001

Year	Failed Institutions				Estimated Loss to FDIC		Estimated Loss / Assets (b)	
	Banks		Thrifts					
	Number	Total Assets ($ Millions)	Number	Total Assets ($ Millions)	Banks ($ Millions)	Thrifts ($ Millions)	Banks (Percentage)	Thrifts (Percentage)
1986	145	7,638			1,728		23	
1987	203	9,231			2,028		22	
1988	221	52,683			6,866		13	
1989	207	29,402			6,215		21	
1990	169	15,729			2,889		18	
1991	127	62,524			6,037		10	
1992	122	45,485			3,707		8	
1993	41	3,527			655		19	
1994	13	1,402			208		15	
1995	6	753	0	0	104	0	14	
1996	5	183	1	35	43	14	24	40
1997	1	26	0	0	4	0	14	
1998	3	370	0	0	179	0	48	
1999	7	1,424	1	63	838	1	59	2
2000	6	378	1	30	39	1	10	5
2001 (c)	3	59	1	2,300	5	500-1,000 (d)	8	20-45 (d)

(a) Information based on SAIF thrift insured institutions after the FDIC became responsible for them on July 1, 1995
(b) Weighted average
(c) Through September, 2001
(d) Estimated by press

FDIC RESOLUTIONS OF BIF INSURED BANKS, 1995-2001

1995

Name	Location	Date	Total Assets ($ Thousands) (A)	Estimated Loss ($ Thousands) (B)	Loss Rate (Percentage) (B) / (A)
Los Angeles Thrift and Loan Company	Los Angeles, CA	3/31/95	21,449	5,932	28
Pacific Heritage Bank	Los Angeles, CA	7/28/95	151,108	37,300	25
Bank USA, N.A.	Kihei, HI	5/19/95	9,361	1,600	17
Founders Bank	New Haven, CT	7/28/95	76,279	9,000	12
First Trust Bank	Ontario, CA	3/3/95	217,814	23,007	11
Guardian Bank	Los Angeles, CA	1/20/95	277,013	27,574	10
Total			**753,024**	**104,413**	**14**

1996

Name	Location	Date	Total Assets ($ Thousands) (A)	Estimated Loss ($ Thousands) (B)	Loss Rate (Percentage) (B) / (A)
Metrobank	Philadelphia, PA	3/8/96	35,009	10,900	31
First National Bank of the Panhandle	Panhandle, TX	6/14/96	62,722	17,835	28
Fairfield First Bank & Trust Company	Southport, CT	7/12/96	50,896	9,800	19
Peoples Bank and Trust	Borger, TX	5/31/96	21,134	3,300	16
Commonwealth Thrift and Loan	Torrance, CA	8/16/96	12,741	1,400	11
Total			**182,502**	**43,235**	**24**

1997

Name	Location	Date	Total Assets ($ Thousands) (A)	Estimated Loss ($ Thousands) (B)	Loss Rate (Percentage) (B) / (A)
Southwest Bank	Jennings, LA	11/21/97	25,921	3,500	14
Total			**25,921**	**3,500**	**14**

1998

Name	Location	Date	Total Assets ($ Thousands) (A)	Estimated Loss ($ Thousands) (B)	Loss Rate (Percentage) (B) / (A)
Best Bank	Boulder, CO	7/23/98	318,024	171,586	54
Q Bank	Fort Benton, MT	8/7/98	14,057	5,073	36
Omni Bank	River Rouge, MI	4/9/98	38,319	2,317	6
Total			**370,400**	**178,976**	**48**

FDIC RESOLUTIONS OF BIF INSURED BANKS, 1995-2001 (Con't)

1999

Name	Location	Date	Total Assets ($ Thousands) (A)	Estimated Loss ($ Thousands) (B)	Loss Rate (Percentage) (B) / (A)
First National Bank of Keystone	Keystone, WV	9/1/99	1,045,861	770,000	74
Pacific Thrift and Loan Company	Woodland Hills, CA	11/19/99	116,756	52,000	45
Zia New Mexico Bank	Tucumcari, NM	4/23/99	13,354	3,792	28
East Texas National Bank	Marshall, TX	7/9/99	112,632	10,619	9
Peoples National Bank of Commerce	Miami, FL	9/10/99	35,181	2,014	6
Victory State Bank	Columbia, SC	3/26/99	11,782	0	0
Golden City Commercial Bank	New York, NY	12/10/99	88,254	0	0
Total			**1,423,820**	**838,425**	**59**

2000

Name	Location	Date	Total Assets ($ Thousands) (A)	Estimated Loss ($ Thousands) (B)	Loss Rate (Percentage) (B) / (A)
The Bank of Falkner	Falkner, MS	9/29/00	75,681	12,700	17
Town and Country Bank of Almelund	Almelund, MN	7/14/00	24,503	3,605	15
Hartford-Carlisle Savings Bank	Carlisle, IA	1/14/00	113,313	11,127	10
National State Bank of Metropolis	Metropolis, IL	12/14/00	93,011	8,000	9
Monument National Bank	Ridgecrest, CA	6/2/00	10,333	748	7
Bank of Honolulu	Honolulu, HI	10/13/00	61,247	2,500	4
Total			**378,088**	**38,680**	**10**

2001*

Name	Location	Date	Total Assets ($ Thousands) (A)	Estimated Loss ($ Thousands) (B)	Loss Rate (Percentage) (B) / (A)
Sinclair National Bank	Gravette, AR	9/7/01	30,700	4,400	14
Malta National Bank	Malta, OH	5/3/01	9,500	80	1
First Alliance Bank & Trust Company	Manchester, NH	2/2/01	18,400	119	1
Total			**58,600**	**4,599**	**8**

* Through September, 2001

Source: FDIC

FDIC RESOLUTIONS OF SAIF INSURED THRIFT INSTITUIONS, 1995-2001

Year	Name	Location
1996	Union Federal Bank	Los Angeles, CA
1999	Oceanmark Bank	North Miami Beach, FL
2000	Mutual Federal Savings Bank of Atlanta	Atlanta, GA
2001*	Superior Bank	Hinsdale, IL

* Through September, 2001

Source: FDIC

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OCTOBER 16, 2001

Mr. Chairman, I appreciate the opportunity to appear this morning to discuss the lessons for policymakers suggested not only by the Superior Federal Bank failure, but also by other recent closings of insured depositories and the new, post-attack risk context in which these specific cases must be considered. I am the Managing Partner of Federal Financial Analytics, a firm that has advised financial services companies in the United States and abroad for the last 16 years. Federal Financial Analytics has no clients that are parties in the Superior or other recent bank failures before you today.

This hearing was just being convened on September 11 when the planes struck. It is now the first piece of regular business taken up by the Committee since the attack. It is a relief for all of us to discuss Superior FSB, a relatively ordinary failure in the ordinary times that are sadly now behind us. The lessons from the failure—and several prior ones similar to it—are, however, even more pertinent today, when hypothetical risks have now become alarmingly real.

In 1993, I was an adviser to a commission chartered by Congress to examine the causes of the S&L crisis and to make recommendations about ways to prevent another one. One major commission finding that has been cited in many other books on the 1980's crisis: Congress throughout the period was not given reliable information on which to act and, in some cases, it ignored the signs of brewing trouble. As the Commission concluded, "Congress appears to have been largely unaware of the severe problems developing in the S&L industry. . . By the time the extent of the problem was recognized, much of the damage was done." The prompt attention the Superior Federal Bank case is receiving in this hearing and your interest in any action that the case may warrant indicates that one of the more important lessons of the 1980's will guide Congress in 2001.

In this statement, I would like to offer the following recommendations and conclusions, based on the Superior FSB failure, those that preceded it and the new risk profile for the financial services industry:

- The "Prompt Corrective Action" capital standards are not a reliable guide for regulatory intervention because the capital standards on which they rest are flawed and about to become more so. Distortions in capital standards actually create incentives for banks to take risks. This was the case with Superior, because capital incentives encouraged a concentration in high-risk residual assets. It could be the case for the financial system more broadly due to proposed capital rules that will discourage banks from obtaining insurance or otherwise reducing operational risk. Congress should push for rapid action on the recourse/residual rules, and take a close, hard look at pending changes to the international risk-based capital rules.
- No bank regulator has a perfect record in recent bank failures. The FDIC should have expedited authority to review troubled institutions, but no greater authority should be granted to review healthy banks. Doing so would add regulatory burden without any offsetting improvement. Indeed, duplicative regulation could distract resources from emerging risks. Numerous improvements to supervisory practices by all of the regulators should be made.
- The pace of bank and thrift consolidation may make the OCC and OTS overdependent on revenue from a few very large institutions. There is no evidence that this has to date resulted in forbearance, but this could occur with further consolidation. Restructuring of the assessment scheme, including consideration of use of FDIC premiums, should be considered.

Finally, in the context of a hearing examining regulatory failure, it is important also to recognize success. After the September 11 attack, the resources of our Nation's financial system were strained to breaking. Treasury, the Federal Reserve, and the other supervisory agencies all played an important role in acting quickly to quell any panic, right the banking ship, and protect the system from further harm.

I. The Critical Importance of Correct Capital Incentives

In the wake of the banking and thrift crises of the late 1980's, Congress decided to use capital as the criterion for regulatory intervention. This made sense, since one of the other key findings of the 1993 Congressional Commission cited above—along with most other analyses of the time—was that capital forbearance not only precipitated the crisis, but also significantly increased its cost.

The capital-related sanctions can be found in Section 131 of the FDIC Improvement Act of 1991. They are often called the "Prompt Corrective Action" or PCA sec-

tion, based on the Congress' intent that regulators would initiate Prompt Corrective Action when bank or thrift capital fell below designated thresholds. However, the statute does give regulators numerous options to refrain, including flexibility to delay closing a critically undercapitalized institution.

Some have argued that the PCA framework should be more prescriptive so that a primary regulator must close a bank when it fails the critical capital test. However, I am very concerned that an automatic trigger based on a single indicator of bank condition could result in the closing of some healthy banks and the ongoing operation of other, truly insolvent ones. This is because the current measures of capital adequacy on which the PCA tests are based are flawed. Indeed, under current capital standards, a bank with its entire portfolio in risk-free Treasury securities could be subject to higher regulatory capital standards than one like Superior with a portfolio of risky subprime assets.

Further, pending changes to the Basel risk-based capital standards suggest that this problem could become even worse, increasing the already wide variance between the amount of capital a bank needs as determined by the market (economic capital) and that demanded by bank regulators. As discussed in more detail below, the new financial risk environment makes it even more urgent that flaws in both the current and prospective capital standards be quickly remedied. Congress should oversee the capital regulatory process because failures in it could have grave macroeconomic consequences, as well as increase systemic risk.

A. THE ROLE OF RESIDUALS AND OTHER STRUCTURED ASSETS

As noted, the PCA framework is only as strong as the capital rules on which it rests. In 1991, financial markets were far simpler than at present, when financial "engineering" techniques have multiplied the ways risk can be sliced and diced among originators, issuers, and investors. Failures in the capital rules accurately to reflect risk are quickly identified and exploited as banks seek to maximize their return on equity by holding assets that provide the greatest relative return (adjusted for risk) in relation to regulatory capital.

Bank regulators disagreed over the capital condition of Superior Federal Bank as it slid toward regulatory insolvency, and this is one of the disputes now before the Committee. However, the Superior case is not an isolated one. In three other recent bank failures—Keystone, BestBank, and Pacific Thrift & Loan—questions about capital adequacy comparable to those at Superior are also relevant. All four banks engaged in complex securitization transactions that put structured assets, often called residuals, on their books. The appropriate capital treatment for residuals and for other structures in which a bank retains risk, "recourse" in regulatory parlance, remains very crude in relation to the real risks posed by these complex instruments. Further, the accounting valuation of residuals remains at best an art, putting bank regulators at the mercy of accountants whose judgment proved unreliable in each of these recent bank failures.

Unsettled economic circumstances make residual valuation still more problematic. In early September, a major nonbank mortgage servicer took a $2.1 billion write-off of servicing value because of model failures, and market indications are that several other large lenders may be forced to do the same in coming weeks because of the Fed's sharp reductions in interest rates after the terrorist attacks.

Under current capital standards, the real risk of residuals and recourse positions is not captured. In some cases, risk is underpriced in capital terms, creating incentives such as those which drove Superior FSB to amass millions in complex residual interests. In other areas, risk is overpriced. For example, the current rules treat high-quality, asset-backed securities the same as very risky instruments. This significantly reduces the profitability associated with lower-risk assets, creating a perverse incentive for banks to take on more—not less—risk.

Revisions to the recourse and residual capital standards have been pending for almost a decade. Regulators have been slow to act because these instruments are complex and because some institutions profit handsomely from the "risk arbitrage" opportunities created by the holes in the current capital rules. However, this failure to act has had several serious consequences. First, it created the conditions that led not only to the Superior FSB failure, but also to the others cited above. Other institutions may be suffering major revaluations in their residual books, and rapid action on the new capital rule is essential to identify these institutions and bring them into an appropriate PCA framework.

Second, the failure of the capital standards to capture accurately certain risks could now be contributing to ongoing instability in the financial markets. The September 11 attacks struck at the heart of the system for bundling loans into asset-backed securities. The bulk of this market is based on mortgage loans, but many other types of assets that is, credit card receivables—are similarly securitized. Pri-

vate-label asset-backed securities have long labored under a capital disadvantage to those issued by Government-sponsored enterprises because even the highest-rated private securities bear a far higher capital charge than securities backed by the GSE's. Rapid recovery of the securitization market would be enhanced by quick action on the recourse rules, which would remedy this capital handicap and create a quick stimulus to this troubled market. Doing so could help to reduce long-term mortgage rates because lenders would have more ready access to the secondary market, reducing their costs of doing business.

B. ADDITIONAL CAPITAL-RELATED RISKS

Despite awesome stress, the Nation's financial system recovered remarkably quickly from the destruction of the September 11 attack. This was in part the result of heroic work by the Nation's financial regulators. However, it also resulted from the less noticeable years of investment by financial services firms in back-up computer centers, redundant transaction centers, contingency planning, and costly insurance. None of these was cheap, and all reduced return to shareholders, but each proved essential in bringing the financial system back online in remarkably good order in an amazingly short time.

One would assume that bank regulators would seek to build in as many incentives as possible for banks to prepare for reasonable and unreasonable disaster scenarios. However, one proposed change to the international risk-based capital rules would, in fact, create a perverse incentive against disaster preparedness and operational risk mitigation. This is because the proposed rules would impose a specific capital charge against "operational risk," without any discount for banks that have made the extensive investment in disaster recovery cited above.

As with the residual and recourse rules, misplaced capital incentives with regard to operational risk will encourage risk-taking, not reduce it. Rules which are very detailed and highly technical can appear to be "state of the art," but small mistakes or misplaced incentives can have significant, adverse policy consequences.

Another major problem with the rewrite of the international capital standards is its failure to deal well either with portfolio or line-of-business diversification. As a result, institutions with big portfolios of risky loans might not be penalized, nor would those which fail to engage in a prudent mix of businesses where risks tend naturally to hedge each other. This failure could, in fact, create a regulatory incentive for banks to become monoline institutions focusing on the high-risk end of the market. This could lead to more, not fewer, Superior-style failures.

C. SPECIAL U.S. RISKS

The link between PCA and capital under U.S. law makes it especially urgent that the capital rules be properly calibrated to risk. In other countries, banks that fail the Basel or their own domestic capital rules may get a slap on the wrist, if their regulators even do that. However, FDICIA obligates U.S. regulators to take the steps outlined above if the capital slips below stated thresholds. Thus, banks will maintain regulatory capital even if their true risk profile argues for far more—and sometimes far less—regulatory capital. In addition, the link between being "well-capitalized" and being allowed under the Gramm–Leach–Bliley Act to form a financial holding company ties U.S. banks far more closely to the capital standards than is the case in other countries.

The PCA framework and GLBA requirements mean that many bank examiners focus on the letter of the capital requirements, not their spirit. They impose capital sanctions in a mechanical fashion or deem banks to be well-capitalized regardless of their real risk potential. The fact that many Texas banks (such as, First National City) were well-capitalized under the PCA framework on the day they were closed makes it clear that regulatory capital cannot be the sole criterion on which regulators base their supervisory decisions. Superior FSB's precipitous decline from the top of the capital heap to the bottom reinforces this decade-old lesson.

Policy Recommendations

In my view, the PCA framework is a valuable one, as it prevents the endless forbearance that characterized both bank and thrift regulation during the 1980's. However, the serious flaws in the current and prospective capital rules argue strongly against too tight or too mechanical a link between capital and supervisory intervention. Under PCA, there has yet to be a bank liquidation that did not cost the FDIC money, demonstrating that reliance solely on capital as the PCA trigger provide no guarantee against losses to the deposit insurance fund, as Congress intended.

Specifically, I would suggest the following:

- Rapid action by bank regulators to finalize the recourse and residual rules. Congress required the bank regulators to issue the recourse rules in the Riegle–Neal

Act of 1994. The Superior failure and the problems it and others expose with regard to the capital treatment of securitization-related assets makes action on these rules essential;

- Congressional review of the bank capital framework, with particular regard to the emerging Basel rules. In addition to the PCA-related problems outlined above, the rules could have a dramatic and unintended effect on economic growth and on lending to low- and moderate-income borrowers. Congress should ensure that the bank regulators are informed by broad, public policy interests as the capital rules are finalized; and
- The PCA framework should be modified to reduce its reliance on capital. Banks should be upgraded in the PCA framework, as well as downgraded, when non-capital factors affect their risk profile. Further, regulators should make greater use of their power under current law to evaluate noncapital factors (that is, management expertise) and downgrade institutions and impose sanctions accordingly.

II. FDIC Enforcement Power

The Committee is rightly concerned that bank regulators work well together, and that the FDIC be informed early about any emerging problems that might result in a cost to the deposit insurance fund. However, the FDIC already has broad authority to intervene in troubled institutions that are not dependent on cooperation from its sister agencies. For example, the FDIC can terminate deposit insurance at its sole discretion, without regard to whether a primary regulator has decided to close a bank or savings association. Further, the FDIC can under current law notify a primary regulator that it believes that PCA sanctions should be invoked. Should the primary regulator fail to do so, the FDIC can intervene. In the 10 plus years since the FDIC got these powers, they have never been used. This suggests to us that differences of opinion among the regulators are isolated and that these should be resolved through greater Congressional oversight and improved regulatory communication, not through any statutory change.

Indeed, giving the FDIC broader authority could well be problematic. There appears to be little reason to give the agency automatic authority to examine healthy banks, especially the large ones that are already subject to double and in some cases triple or more supervision from a variety of bank and nonbank regulatory bodies. Further, the FDIC has little experience with specialized, sophisticated institutions. While it might like to learn on-the-job to anticipate potential problems, its entry into such institutions would add considerable regulatory burden without any discernible benefit.

Indeed, supervision of all insured depositories might be improved if the FDIC worked with other bank regulators to take advantage of their expertise. While Superior and Keystone are the largest and most costly recent bank failures, the FDIC has had two smaller ones of its own. BestBank of Colorado failed in 1999 due to very dubious management practices and questionable lending, while Pacific Thrift & Loan failed largely because of the same problems with residuals that toppled Superior. In both cases, the FDIC let as many as 5 years lag between the time at which it first spotted trouble and the time the banks were closed. Through these years, the FDIC appeared as reluctant to second-guess management and accountants as its sister agencies in the Keystone and Superior cases. In the era of emerging risk in which we find ourselves, it is essential that bank regulatory resources be deployed as effectively as possible, and this would argue for an FDIC focus on its own supervisory concerns, not on those under the purview of other financial supervisors. The FDIC can also make a contribution toward improving the safety of the financial system as a whole by moving rapidly on fundamental reform to the deposit insurance system to eliminate the incentives to risk-taking endemic within the premium structure of the deposit insurance funds.

Policy Recommendations

Supervising banks engaged in complex activities during trying economic times is hard work for each agency charged with doing so. When bank management is engaged in systematic fraud or desperate practice, all of the regulators face a still more daunting task. None has a recipe for total success, and each would benefit from improving communications with the others and from more general reforms to bank examination. These could include:

- Tighter scrutiny of and, in some cases, sanctions against bank management. When management and/or major shareholders are big borrowers from their own institutions or have a record of association with other troubled institutions, supervision should be far more stringent. Bank examiners should consider making use of their PCA powers to impose a higher capital burden on closely held institutions, especially those engaged in high-risk or insider-related lines of business.

- Requiring that only the head of another regulatory agency may decline a request from the FDIC for joint examinations.
- Reviewing depository institution accounting standards, especially with regard to complex securitization-related assets and derivatives exposures. Bank regulators have long resisted market-value accounting because this could expose institutions to earnings volatility. However, historical cost accounting protects institutions from quick recognition of losses, which increases the likelihood of deeper losses down the road. Current accounting practices also reduce market discipline and encourage regulatory forbearance, since banks may look far healthier than they actually are.
- Reinstating the report process related to high-growth institutions mandated in FIRREA. In 1995, the FDIC decided to terminate its guidance in this area, despite substantial evidence that banks that grow very fast for reasons not associated with mergers or acquisitions pose a disproportionate risk to the deposit insurance funds.
- Reconsideration of the current policy against disclosure of CAMELS ratings. Bank regulators have long opposed public disclosures, fearing this would exacerbate liquidity problems at troubled banks. However, they are proposing both within the United States and in the Basel process to institute a series of highly complex and, in some cases, very burdensome new disclosure requirements. A simpler disclosure with regard to a bank's condition would significantly improve market discipline, especially in the absence of a proper relationship between deposit insurance premiums and bank risk.
- Creating teams of specialized examiners on call to any Federal financial supervisor. This would encourage the cost-effective development of experts in highly complex areas such as asset securitization and the proper valuation of residuals, while minimizing the number of duplicative exams to which the institutions are subject. Regulators might also be required to have their own or to share teams of specially trained anti-fraud examiners, whose law enforcement orientation might improve supervision in cases like Keystone.

III. Examination Fees

It is also possible that the dependence of certain regulators on assessment fees could create problematic supervisory incentives. At present, we do not see any evidence that fees have played any role in recent supervisory decisions by the OCC and OTS. Indeed, as these agencies note, problem institutions generally cost the agencies far more in supervisory resources and, in some cases, court costs than they provide in fees. Further, both agencies experience what they call reputation risk when an institution fails on their watch, as is evident not only from today's hearing, but also from earlier ones in the House after Keystone's collapse.

However, the fact that fees are not now problematic does not mean that they will not become so in time. The consolidation in the banking industry means that the OCC and OTS are increasingly dependent on a few very large institutions for the bulk of their revenue. This is particularly true at the OTS, where one very large savings association dwarfs the rest of the industry in terms of market size and, therefore, assessment fees. Loss of such an institution to another regulator could be costly, and it is therefore possible that an agency head might be more inclined to work with such a bank than with a smaller one with less impact on the agency's bottom line.

But while the shape of the looming problem with assessments is clear, the cure is less so. Bringing the OTS and OCC under the appropriations process is, in my view, highly ill advised. The problem with appropriating supervisory resources is evident at OFHEO, the safety-and-soundness regulator for Fannie Mae and Freddie Mac. Due to budget and other pressures, Congress consistently appropriates less for OFHEO than the agency requests, giving it fewer resources with which to supervise its charges than is the case at the OCC and OTS for very large institutions.

The OCC has suggested that the premiums paid by national banks and Federal savings associations to the FDIC be used also to pay for bank supervision, as is the case for State nonmember banks. Doing so would ensure that the FDIC uses its resources wisely, while eliminating an obvious inequity between the Federal and State charters. However, it is very difficult to identify precisely which portion of the FDIC's premiums should be subtracted to compensate Federally chartered institutions. Further, doing so could reduce the resources available to absorb losses to the deposit insurance funds, increasing the prospect of rapid increases in industry-wide premiums or even, under extreme circumstances, taxpayer assistance. Finally, calibrating the amount repatriated to Federal supervisors would become far more difficult when truly risk-based premiums are instituted.

In light of these concerns, I recommend that:

- Congress consider the issue of Federal examination fees in the context of pending proposals to reform deposit insurance. Specifically, Congress might consider allocating a portion of the premiums paid by each Federally chartered bank and savings association as a supervisory charge, rebating these fees back to the primary regulator for as long as the deposit insurance funds stay above their designated reserve ratios.

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EDMUND L. JENKINS
Chairman

October 15, 2001

The Honorable Paul S. Sarbanes
United States Senate
Washington, DC 20510

Dear Mr. Chairman

I recently became aware of the prepared testimony of The Honorable Ellen Seidman, Director, Office of Thrift Supervision, submitted to the Committee on Banking, Housing, and Urban Affairs ("Committee") in connection with your hearing on "The Failure of Superior Bank, FSB, Hindsale, Illinois ("Superior")."

Director Seidman's testimony includes a discussion of "accounting and financial reporting issues" (pages 40-48). That discussion contains references to the Financial Accounting Standards Board's ("FASB" or "Board") Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("Statement 140"), and the Statement it replaced, Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("Statement 125") (Statements 140 and 125 collectively, the "Statements"). That discussion also includes the following recommendation:

> We . . . 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. [page 44]

With respect to Director Seidman's first recommendation that the FASB "conduct a formal impact study" prior to the issuance of an accounting standard, I have significant concerns that such a recommendation, if adopted, would result in a fundamental and, in my opinion, harmful change to the FASB's long-established due process procedures.

With respect to Director Seidman's second recommendation that the FASB "consult with the FBAs regarding the potential impact of the change or revision" prior to the issuance of an accounting standard, I would like to emphasize that the FASB's procedures presently include *extensive* consultations with the Federal Banking Agencies ("FBAs") on all FASB activities that have "a potential major impact on banks and thrifts." The FASB's open and public due process that resulted in the issuance of the Statements was no exception.

The FASB is an independent private-sector organization. We are not part of the federal government and receive no federal funding. We are funded entirely from private-sector sources, primarily voluntary contributions and sales of publications.

The mission of the FASB is to establish and improve standards of financial accounting and reporting for both public and private enterprises. The FASB operates under Rules of Procedure that require an extensive due process that is open to public observation and participation. That due process has proven to produce the best accounting standards possible, and the proof is that the United States capital markets are the deepest, most liquid, and most efficient markets in the world.

The provisions contained in the Statements were deliberated and developed at public Board meetings over a six-year period from 1994 to 2000. During that time, the Board issued 2 proposals for public comment, carefully analyzed and reviewed over 150 comment letters received from a broad range of constituents, held public hearings in which 24 individuals and organizations presented their views, and conducted limited field testing on 2 different occasions of various provisions contained in the proposals.

During the six-year period that the Board was developing the Statements, the Board's communications with the FBAs about issues raised by the provisions contained in the Statements were extensive. For example, the FASB's Financial Instrument Task Force, which periodically met with and advised the Board about the Statements, included an FBA representative. Other communications with the FBAs included dozens of telephone calls, facsimiles, and emails exchanged between FASB and FBA representatives about the Statements. Communications with the FBAs also included over two dozen face-to-face meetings between FASB and FBA representatives. Those meetings included discussions of issues raised by the Statements, including issues relating to the accounting and reporting of securitizations and residual interests that are referenced in Director Seidman's testimony.

The focus of the FASB is on consumers—users of financial information, such as investors, creditors, and others. The FASB attempts to ensure that corporate financial reports give consumers an informative picture of an enterprise's financial condition and activities and do not color the image to influence behavior in any particular direction.

Essential to developing accounting standards that result in credible and transparent information is that the information must be neutral. Neutral information reports economic activity as faithfully as possible, without coloring the image communicated in order to influence behavior in any particular direction. Neutral information is information free from bias toward a predetermined result.

The notion of neutrality is a fundamental element of the FASB's standard-setting process. The FASB's Rules of Procedure explicitly require that the Board be objective in its decision making to ensure the neutrality of information resulting from its standards.

Neutrality is an essential criterion by which to judge financial reporting standards, because information that is not neutral loses credibility and value. For example, surely, we would all agree there would be little value to Congress or the FBAs of purposely altered and manipulated information about the rate of inflation or about unemployment. Similarly, to create or to tolerate financial reporting standards that bias or distort financial information to favor a particular transaction, industry, or special interest group undermines the proper functioning of the capital markets and impairs investors' capital allocation decisions.

The adverse consequences of abandoning neutrality is, perhaps, best illustrated by the savings and loan crisis. During the 1970s and 1980s many argued that the application of generally accepted accounting principles ("GAAP") would force regulators to close savings and loan institutions and that institutions using GAAP would not be able to compete in development and commercial lending.

Preserving the industry became an overriding objective. Consequently, accounting principles were superseded by regulatory requirements, and the resulting lack of transparency (from accounting that was far from neutral) masked the problems. L. William Seidman, the Federal Deposit Insurance Corporation's Chairman at the time, called what happened "the worst mistake in the history of government."

Director Seidman's recommendation that the FASB issue an improvement to financial accounting and reporting only after it has conducted a "formal impact study" is fundamentally inconsistent with the notion that decision-useful information must be neutral. At a minimum, it would likely create the perception that the FASB's standards and the resulting information have been manipulated to mask the true economic activity of banks and thrifts. It also would likely introduce unnecessary pressures and delays into the standard-setting process that would not benefit consumers. Individually, or in combination, the perception, pressures, and delays could have significant adverse consequences for the cost and availability of capital.

I respectfully request that this letter be included as part of any official record of the Committee's oversight of Superior. If you have any questions about the contents of this letter or would like any additional information, please feel free to contact me directly, or our Washington, DC representative, Jeff Mahoney, at 703-243-9085.

Sincerely,

Edmund L. Jenkins

CC: The Honorable Christopher J. Dodd
The Honorable Tim Johnson
The Honorable Jack Reed
The Honorable Charles E. Schumer
The Honorable Evan Bayh
The Honorable Zell Miller
The Honorable Thomas R. Carper
The Honorable Debbie Stabenow
The Honorable Jon Corzine
The Honorable Daniel K. Akaka
The Honorable Phil Gramm
The Honorable Richard C. Shelby
The Honorable Robert F. Bennett
The Honorable Wayne Allard
The Honorable Michael B. Enzi
The Honorable Chuck Hagel
The Honorable Rick Santorum
The Honorable Jim Bunning
The Honorable Michael D. Crapo
The Honorable John Ensign
The Honorable Ellen S. Seidman

RESPONSE TO WRITTEN QUESTION OF SENATOR SARBANES FROM ELLEN SEIDMAN

Q.1. I understand that there is still some uncertainty regarding what will be the net loss to the Savings Association Insurance Fund (SAIF) from the failure of Superior Bank. I am concerned that another failure of similar cost could cause the SAIF ratio to fall below 1.25. Using the latest FDIC information from June 2001, the SAIF had a balance of $10.79 billion covering insured deposits that were worth $772.9 billion. This places the current SAIF ratio at approximately 1.40 percent. I understand that in these figures some money has already been taken to deal with the Superior failure, on the order of $300 million. Ms. Seidman, if the net cost to the SAIF from the Superior failure is $750 million, and holding the deposit base constant, what would be the size of another failure or set of bank failures that would cause the SAIF ratio to fall below 1.25?

A.1. The failure of Superior Bank will reduce the SAIF's excess reserves, but the fund can absorb these losses and maintain a cushion above its 1.25 percent designated reserve ratio. As of September 30, 2001, the SAIF held reserves of $10.8 billion against $779.2 billion in insured deposits, a reserve ratio of 1.39 percent. The SAIF's excess over its designated reserve ratio was $1.1 billion.

When the FDIC approved the sale of Superior Bank on October 31, 2001, they estimated that the loss to the SAIF would be between $450 million and $550 million. At that time, the fund held specific reserves of $450 million for Superior (for example, apart from the $10.8 billion), so this would imply additional potential losses of up to $100 million. Subtracting $100 million from the SAIF would leave its reserve ratio at 1.38 percent, with $975 million in excess reserves. In your question, you cite an early, unofficial estimate that the failure could cost the SAIF $750 million, in which case the SAIF's reserve ratio would fall to 1.35 percent, with remaining excess reserves of $775 million.

The SAIF's losses from Superior Bank are mitigated by the agreement made in December 2001 between the OTS and the FDIC and the holding companies of Superior Bank. Under this agreement, the holding companies have agreed to pay the FDIC $460 million, of which $100 million has already been paid out and the remainder will be paid out over a 15 year period. In addition, Superior's deposit base was sold at a substantial premium. It is our understanding the FDIC expects to have an adjusted loss estimate for Superior in the near future.

The failure of Superior Bank was quite costly to the SAIF, but the fund was able to absorb these losses without severely depleting its reserve cushion. While future failures are always a possibility, the fund is not currently facing problems that might imperil its ability to remain fully capitalized. As of September 30, 2001, there were 17 OTS-supervised institutions with $3.6 billion of assets on the problem list, only three of which, with aggregate assets of $400 million, were less than adequately capitalized. Of course, these numbers can fluctuate significantly over time.

RESPONSE TO WRITTEN QUESTION OF SENATOR SARBANES FROM JOHN REICH

Q.1. As of June 2001, the Savings Association Insurance Fund (SAIF) had a balance of $10.79 billion covering insured deposits that were worth $772.9 billion. This places the current SAIF ratio at approximately 1.40 percent. Holding constant the deposit base, what amount of additional losses to the SAIF would cause the fund ratio to fall below 1.25?

A.1. Losses exceeding approximately $1.1 billion would lower the SAIF reserve ratio below 1.25 percent if SAIF-insured deposits are held constant at the June 30, 2001 estimated amount of $772.9 billion. This calculation does not include interest income on the SAIF balance.

This calculation would not significantly change using the September 30, 2001 data. As of that date, the SAIF balance was $10.8 billion. Estimated insured deposits were $779.2 billion, resulting in a SAIF reserve ratio of 1.39 percent. Holding SAIF-insured deposits constant at this level, it would again require losses exceeding approximately $1.1 billion to lower the SAIF reserve ratio below 1.25 percent (ignoring, as before, interest income).