



Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Financial and Banking Crisis

Training Program ~ 16 – 22 September 2009

**Mr. David Jones
Program Leader and Academic Coordinator**

Pre-Course Readings

Resources

Participants will receive handbooks containing all material presented throughout the program, along with supporting papers from a number of the presenters. Participants will also be provided with links to a number of websites and other appropriate resources by individual presenters during the progress of the course. The program is designed to be highly interactive, and participants are encouraged to ask questions throughout.

Resources provided should also be used as a personal reference library for "post" course reflection.

Information Exchange Workshops

There are a number of opportunities for participants to exchange views and share their experiences, particularly those related to the Financial Crisis, and Basel Accord. These comprise the following sessions within the syllabus:

Session 1.2. Interactive Workshop – Regulatory Responses to the Financial Crisis.

Session 1.3. Participant Presentations – APEC Experience in the Financial Crisis

Session 1.6. Participant Presentations – APEC Economies and Basel II

Participants are requested to do sufficient personal pre-course preparation so they can contribute meaningfully to these workshops, and to bring a small number PowerPoint slides with them, to which they can speak on a "country by country" basis.

Specific Topic Workshops

These workshops provide practical exposure to relevant topics.

Session 2.2. Introduction to “Value at Risk”

Session 2.5. Interactive Workshop – Bank Risk Management Failures.

Note: participants are requested to read the contents of Appendix 1 before attending the program. They will be allocated to syndicates to consider one of these case studies and present their findings.

Session 3.6. Asset & Liability Management

Session 6.4. Workshop – Case studies on Operational Risk Management

Major Syndicate Presentation

In session 1.7, participants will be allocated to one of 4 syndicate groups to consider a particular topic on which they will work during the program, and make a formal presentation on the final day in session 7.5.

They will be requested to consider one of the following topics:

- The role of Deposit Insurance in an overall regulatory framework
- With experiences recently gained, how should regulators now deal, case by case, with failed banks?
- What is an ideal financial Regulatory Agency structure, including the roles of the individual agencies?
- How should the Basel agenda be taken forward?

Additional context will be provided in briefing session 1.7.

Pre-Course Reading

As mentioned earlier, participants are requested to make themselves familiar with the contents of the appendix to this document prior to attendance as specific preparation for Workshop 2.5.

There is a richness of background information on the main topics covered in the program available on the World Wide Web, and participants are encouraged to research according to their personal needs.

A small number of website references are specifically recommended:

The Financial Stability Forum, and their statement on 2 April 2009:

www.financialstabilityboard.org
www.financialstabilityboard.org/press/pr_090402b.pdf

The G 20 Leaders Statement on 2 April 2009:

www.g20.org/Documents/final-communique.pdf

Australian Regulator, APRA Recent Letter to CEOs on Regulatory Change:

www.apra.gov.au/ADI/upload/Enhancements-to-Basel-II-capital-framework-15-Jul-09-Final.pdf

Turner Report to the UK's FSA:

www.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml

Contemporary Basel II Announcements and Developments:

www.bis.org/publ/bcbsca.htm

Australian Regulator APRA – useful pre-reading for session 2.4:

www.apra.gov.au/PAIRS/upload/PAIRS_Final_May_2008_External_Version.pdf

www.apra.gov.au/PAIRS/upload/SOARS_Final_May_2008_External_Version.pdf

Australian Regulator APRA – useful pre-reading for session 2.7:

www.apra.gov.au/ADI/upload/Final-APS-210-November-2007.pdf

www.apra.gov.au/ADI/upload/AGN-210-1-Liquidity-Management-Strategy.pdf

www.apra.gov.au/ADI/upload/Final-AGN-210-2-November-2007.pdf

www.apra.gov.au/ADI/upload/Final-AGN-210-3-November-2007.pdf

Reserve Bank of Australia – useful pre / post course reading for session 3.2:

www.rba.gov.au/PublicationsAndResearch/Conferences/2008/Kearns_Lowe.pdf

www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_jun09/Pdf/bu-0609-2.pdf

Appendix

Session 2.5 Bank Risk Management Failures: case studies

In this session, the groups will study and report back on the particular case study allocated to them. In particular each group should aim to outline and draw lessons about the following aspects of the case study:

- (a) What were the principal features of the business model adopted by the bank, including objectives, range of activities, organizational structure, growth etc? What particular risks might one expect arising from this business model?
- (b) The nature and timing of the “failure” and major factors involved.
- (c) What were the apparent failings in risk management processes, governance, and regulatory oversight?
- (d) Could the problems have been identified beforehand?
- (e) How were the problems resolved, and what alternatives might have been considered?

CASE 1: Northern Rock

Northern Rock emerged as an important player in UK mortgage lending following its creation from a merger of two mutual building societies in the 1960s and subsequent demutualization in October 1997. It grew rapidly from around £ 15 bill assets after demutualization to £ 100 bill assets in 2006. It had 8% of the mortgage market and 2% of £ bank deposits in 2007, and it sold 19% of all new home mortgages in the UK in the first half of 2007. It focused on home mortgage lending, using an “originate to distribute” model, whereby mortgages originated would be securitized and sold into wholesale markets. It was an “aggressive” lender providing high loan to valuation loans. Retail deposits were just over 20% of total assets.

Its June 2007 interim report listed its funding as follows.

£ millions	Retail	Non-Retail	Securitisation	Covered Bonds
2007 1st Half				
Net flow	1,734	2,509	5,632	2,194
Closing balances	24,350	26,710	45,698	8,105

Total equity (including subordinated notes) was £ 3,382 mill. Total assets of £ 113,503 mill comprised £96,659 mill of advances, of which around £50,000 mill were securitized (although included on the consolidated balance sheet – due to residual exposure) and the rest either funded directly on balance sheet or by way of covered bonds.

Early in 2007, Northern Rock received approval from the FSA to use the internal ratings based approach for calculation of capital adequacy requirements.

In August 2007, interbank loan interest rates and wholesale market rates increased substantially.

“It should be recognised that the key dependency for Northern Rock was not its use of wholesale funding per se. In terms of its net short term wholesale funding to balance sheet asset ratio it was not a significant outlier in relation to other UK banks. Rather, its key dependency was its use of securitisation; Its securitisation product was a simple one, based on high quality assets. The market disruption did not affect Northern Rock's existing securitisations, but the market for new securitisations had largely closed. Neither did the market disruption lead to a cessation of Northern Rock's wholesale funding, but rather to a shortening of its duration and an increase in its price. The combination of these factors led the Northern Rock Board to seek assurance that contingency funding from the Bank of England would be available. The large retail outflows in mid September led to a significant and sudden deterioration in Northern Rock's liquidity and required it to draw on the Bank of England facility. So it is clear that a combination of circumstances led to the position which Northern Rock is now in, rather than any single event.”
<http://www.fsa.gov.uk/pubs/other/tsc.pdf> 5 Oct, 2007.

Options identified for dealing with Northern Rock's funding difficulties included (a) Northern Rock's own dealings in short term money markets (b) arranging takeover by a larger player (c) accessing liquidity support facilities from the government.

Retail depositors “ran” on the bank on Sept 14, 2007. The UK authorities had announced a liquidity support package, but not assured depositors that their funds were safe, relying on a deposit insurance scheme which fully guaranteed GBP 2,000 plus 90% of the next 33,000 of deposits. The Tripartite (Treasury, Bank of England, FSA) statement said “The FSA judges that Northern Rock is solvent, exceeds its regulatory capital requirement and has a good quality loan book.” On September 17, the UK government announced a complete guarantee of deposits in Northern Rock.

The CEO of the FSA commented in October that “In terms of the probability of this organisation getting into difficulty, we had it as a low probability.”

On February 17th, 2008 the government announced plans to nationalize the bank following the failure of alternative private sector takeover proposals to be approved.

Extracts from the FSA Summary (26 Mar 08) of its Internal Audit of its supervision of Northern Rock

1. From early August 2007, conditions in credit markets deteriorated and Northern Rock experienced increasing difficulty in securing wholesale market funding. From 9-August, the FSA took part in daily discussions with the other Tripartite authorities to discuss the latest market conditions. The significance of 9 August, therefore, is that it was the start of what can be termed ‘the crisis period’. The scope of this review excludes the crisis period.
2. The extent of the market disruption that occurred in the crisis period – to wholesale funding markets, including securitisation markets – was generally not foreseen by commentators. It was the crystallisation of a low probability, high impact risk. It prompted the need for Northern Rock to seek emergency liquidity assistance from the Bank of England; ultimately, it prompted the run on Northern Rock's retail deposits.
3. In April 2004, the FSA effected a major re-organisation,
4. From the start of our review period to June 2006, Northern Rock was supervised in a department whose primary responsibility was for insurance groups. Between June 2006 and February 2007, Northern Rock was supervised by a team which had responsibility for one other group – an insurance group. From February 2007 to the end of the review period, it was supervised with

deposit-taking peers. As a consequence of these moves, Northern Rock was the responsibility of three heads

5. The supervisory process (review held at 20 Feb 2006) included an overview of the firm's strategy and business, its principal activities, capital and liquidity positions, and nature of funding, as well as a summary of management and of the control environment. We were unable to assess the content of the analysis alongside what key Northern Rock executives and the external auditors had contributed during the discovery work because, contrary to ARROW I and ARROW II standard practice, formal records of key meetings were not prepared.
6. No developed Financial Analysis was provided to the supervisory team]. Comparison would have shown Northern Rock, relative to its peers, as having a high public target for asset growth (15-25% year-on-year) and for profit growth; a low net interest margin; a low cost:income ratio; and relatively high reliance on wholesale funding and securitisation.
7. [Decided] not to issue a Risk Mitigation Programme (RMP), ... lengthening the supervisory period to 36 months, from the 24 months proposed ... against a backdrop of the FSA's publicly stated objective that 'we should create incentives for firms to do the right thing in return for a regulatory dividend – that is less regulatory intervention'³ where the FSA judged that their behaviour (including in their regulatory relationship) and the quality of their management, merited it.
8. Issues that would be addressed in its Close and Continuous (C&C) supervision. These included: the viability of the firm's strategy in the prevailing market conditions, and the firm's capacity to deliver its strategic objectives whilst ensuring that its credit risk profile remained consistent with its risk appetite; that its access to funding, particularly through securitisation, was maintained; the adequacy of its stress-testing; on-going developments of the firm's risk management framework, particularly with respect to Basel; the operational risks arising from its rapid pace of growth; and the mitigation of the internal and external risks associated with the impending retirement of the Finance Director.
9. • the Panel process resulted in a number of the key risks – among them the viability of the firm's strategy, including its need to maintain its access to funding, particularly through securitisation – being drawn out for the supervisory team to pursue;
 - those risks were not effectively pursued by the supervisory team in line with Northern Rock's increasing business risk profile and control framework;
 - the lack of formal risk re-assessment, of recording of issues in IRM and of escalation of the risks which emerged during the supervisory period meant that there was no trigger to re-assess the level of supervisory resource nor to increase FSA management scrutiny;
10. The FSA's approach to liquidity reflected a presumption that, in the event of a crisis like that experienced in August 2007, general market liquidity provided by the Bank of England would be increased and, *in extremis*, liquidity would be provided for systemically important institutions.

CASE 2 *All First and Allied Irish Banks*

In early 2002, Allied Irish Banks (AIB) announced that its US subsidiary Allfirst Financial had incurred a loss of US\$674 million on unauthorised foreign exchange trading by its employee John Rusnak. The USD 674 mill corresponded to \$293 mill in bogus assets and \$380 mill in unrecorded liabilities which were discovered in an audit of the accounts. The loss wiped out about 60 per cent of Allied Irish's earnings for that year. (A detailed report by Promontory Financial Group (commissioned by AIB) giving details is available on the website <http://www.aibgroup.com>).

AIB took full ownership of Allfirst in 1989 and the organisational structure is shown in the attached figure. Rusnak was appointed as a forex trader (and later made manager of the area) in 1993, having had experience trading forex options. He was an active trader, well entertained by broker clients, was not excessively remunerated and appeared to live a modest lifestyle.

AIB did not have a large forex operation (one other trader). Rusnak claimed to be engaged in "arbitrage" trading, buying and selling forex options and hedging the risk associated with currency movements. In reality, Rusnak was undertaking directional trading (forward positions and deep in the money options).

In 1997, Rusnak bought Yen forward and made losses on that position. To hide losses, Rusnak undertook bogus option trades. This involved, for example, buying and selling identical, deep in the money, put options with the same counterparty for the same premium, but where the option sold expired on the same day and the other had a long time to expiry. The internal system did not pick up the (sold) options expiring (unexercised) on the same day. The back office did not collect confirmations of the trades – since they were offsetting transactions with the same party.

(Question: What immediate cash flow is involved in the pair of transactions? Should it have been obvious (to anyone with a knowledge of options) that something "dodgy" was happening? What would be the position recorded in the bank's accounts?)

Rusnak had the bank open a prime brokerage account whereby spot forex deals with other parties were swapped into forward transactions with the broker and all settled at a future fixed date (eg end of month). Thus, for example, if Rusnak bought 100Yen spot from (a) and sold 50 Yen spot to (b), counterparties (a) and (b) would undertake spot settlement with the broker. Rusnak (Allfirst) would have a net forward position of long Yen 50 with the broker (at the derived forward exchange rate).

(Question: How might this arrangement have facilitated a larger volume of trading by Rusnak (without discovery by Allfirst?)

In January 2001 the bank introduced a charge for "balance sheet usage" by trading positions – such that traders were expected to generate profits sufficient to meet the required rate of return on bank capital allocated for the level of risk involved. Rusnak had low income by this measure and would need to reduce trading activity.

In February 2001 Rusnak sold deep in the money options for a large premium income. Rusnak undertook bogus purchases of deep in the money options matching the real options sold.

Allfirst used a Value at Risk model to ensure trading limits were observed and determine capital allocations. At the end of each day, data was collected on transaction undertaken, including a spreadsheet

from Rusnak on “holdout” transactions – those undertaken late in the day, and not yet entered into the bank’s systems. The VaR was calculated incorporating that data.

(Question: What could Rusnak do late in the day to artificially alter the VaR number calculated? Would this manipulation be picked up by the bank’s systems?)

In December 2001, the supervisor of the back office staff noticed that confirmations had not occurred. Senior management also became concerned about the volume of trading and started to close positions outstanding. Rusnak produced some fake confirmations....didn’t show up for work.....

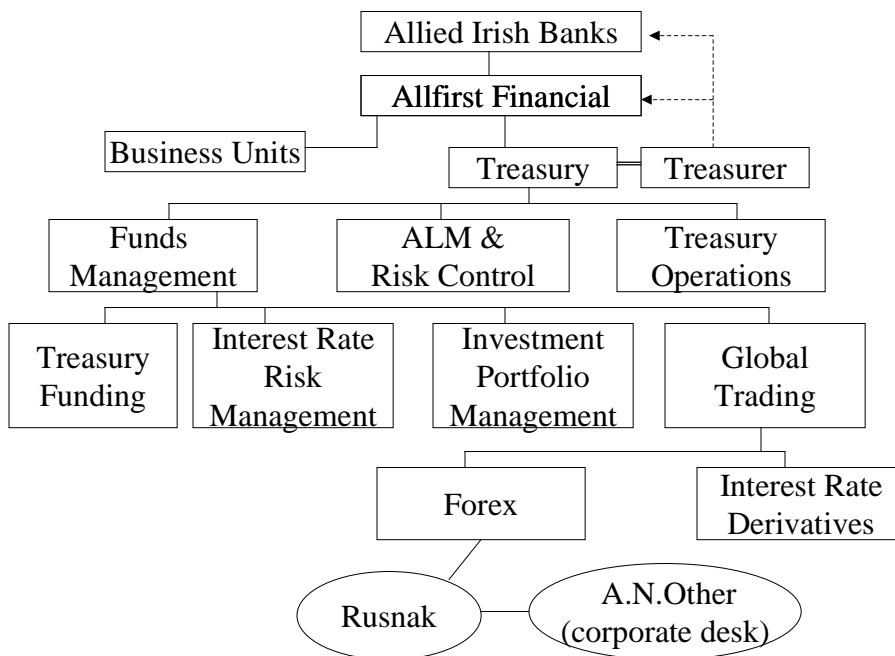
(Question: What control deficiencies appear to have existed?)

(Question: How might the fraudulent activities have been picked up, and by who, if greater diligence had been applied?)

(Question: What characteristics of people, policies, strategy, governance etc do you think might have been relevant in allowing this situation to develop?)

Allfirst’s Personnel and Duties

- Treasurer (Cronin) appointed by AIB, reporting to both AIB and Allfirst. Forex expertise
- Head, Treasury Funds Management (Ray). Interest rate expertise
- ALM – risk control officer – VaR, trading losses, counterparty credit
- Treasury Ops – back office: processing, confirmations, settlement etc.; systems



CASE 3: *Washington Mutual*

Washington Mutual was incorporated in 1889 in the state of Washington in the USA. Over the years since then it had survived economic busts, including the 1929 crash, because it had piled up assets in the flush periods before. However it did not survive the sub-prime crisis and was closed by the Office of Thrift Supervision (OTS) on 25 September 2008.

It was originally known for its ability to adopt, and adapt to, consumer and technological innovations. In the 1970's, Washington Mutual claims to have pioneered the nation's first shared cash machine network, and, along with a group of other savings banks, helped set up the first Pay-by-Phone banking network. In 1983 it bought a brokerage firm (Murphey Favre) and demutualised to become a public company. Murphy Favre's 32 year-old executive vice president Kerry Killinger was retained and became bank chief executive officer in 1990.

During Mr. Killinger's climb up the ladder, the bank hit the doldrums, with lagging profits and earnings. In response, WaMu broke out of its regional niche and adopted new strategies. In July 1996, Mr. Killinger engineered the purchase of the 158-branch California-based American Savings Bank, a \$1.4 billion deal that nearly doubled the size of Washington Mutual, instantly making it the third largest American savings and loan. Other acquisitions included Great Western Bank (1997), Home Savings of America (1998), Bank Unites (2001), Dime Savings Bank of New York (2002), Washington Mutual bank (2005) (then changed its name). It became the nation's top bank in servicing mortgages, and the 6th largest bank in the US. In October 2005, Washington Mutual purchased the "subprime" credit card issuer Provident for approximately \$6.5 billion and WaMu became the 9th largest credit-card company in the US.

In March 2006, Washington Mutual began the move into its new headquarters, WaMu Center, located in downtown Seattle. The company's previous headquarters, Washington Mutual Tower, stands about a block away from the new building on Second Avenue. Mr. Killinger wanted his company compared to Wal-Mart or Southwest Airlines. "Within a year, we'll be put into a different category, as a high-growth retailer of consumer financial services," he was quoted in an article in Fast Company in December 2007. "We'll even start losing the banking label. Then you can put our numbers up against all of the retailers in the country, and you'll have one of the top-growth stories."

Along the way, a new kind of bank was created, catering to middle-class customers at a time when many banks were pulling back from such retail service. Branches sprang up everywhere; with no teller windows or rope lines, they were designed to have the feel of a department store. The primary product was the home mortgage, where WaMu catered to lower- and middle-class consumers that other banks deemed too risky. It offered complex mortgages (eg option ARMs)¹ and credit cards whose terms made it easy for the least creditworthy borrowers to get financing, a strategy the bank extended in big cities, including Chicago, New York and Los Angeles.

¹ Washington Mutual held \$52.9 billion of option ARMs or negative amortization loans, on its books in the second quarter of 2008, with defaults doubling to \$3.2 billion from the end of 2007

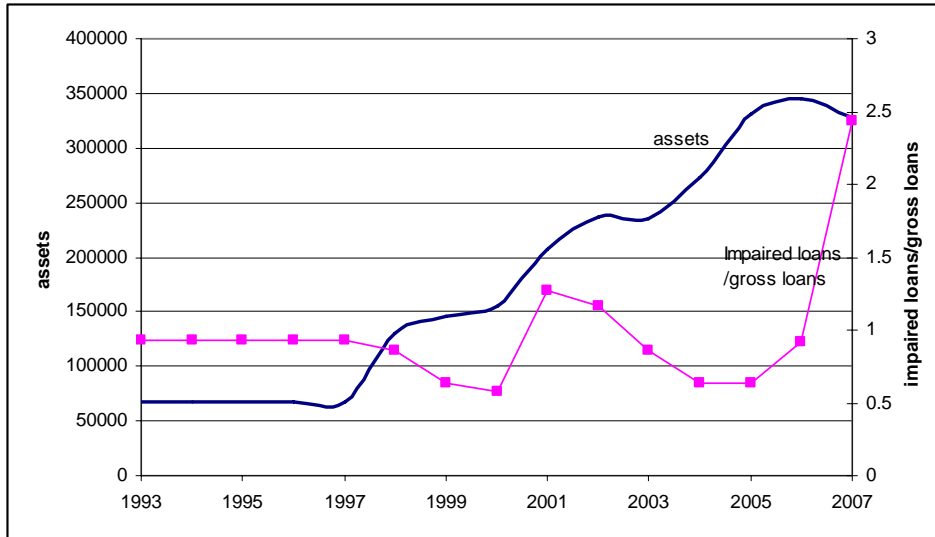
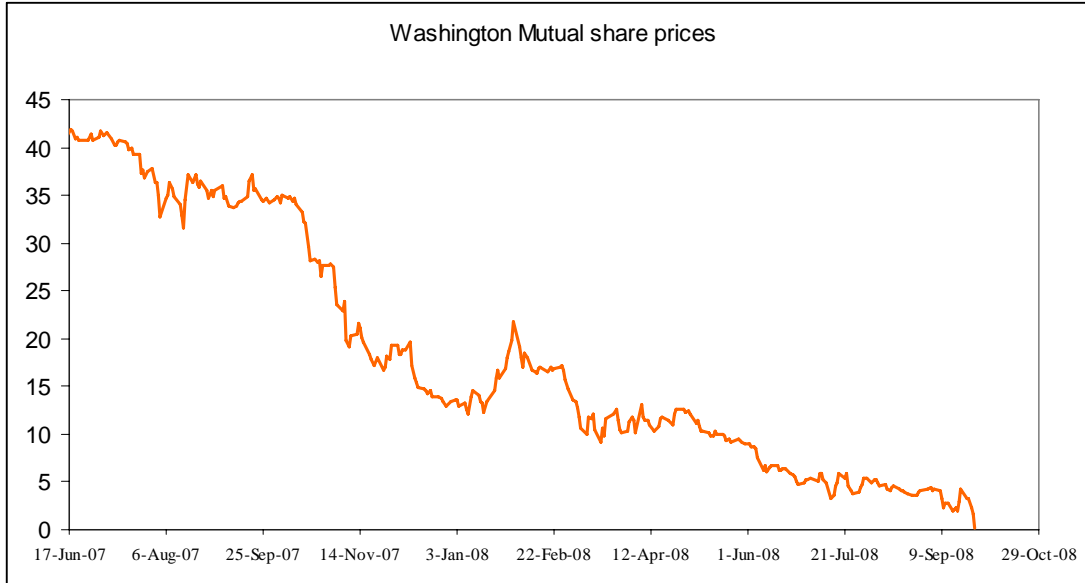


Figure 1: Washington Mutual performance (Source: Bankscope)

Figure 1 shows the asset growth over the years 1993-2007, a growth rate of 386 percent. But losses started to pile up at an alarming pace with the downturn in the housing market, as Figure 1 shows. A strategy that had allowed for the bank's phenomenal growth - focusing on lower-income borrowers - was now responsible for devastating losses. With rising mortgage payments and higher gas and food bills, WaMu's losses in its big credit card loan portfolio also surged. By then, however, WaMu's troubles had set off alarm bells on Wall Street, and the share price plummeted, as Figure 2 illustrates.



With options narrowing, WaMu tried frantically to find a solution and reached out to several banks and big private equity firms. In March 2008, JPMorgan Chase saw an opportunity and urged WaMu in a letter to consider a quick deal. On the same weekend that JPMorgan was negotiating the daring takeover of Bear Stearns, it had executives meeting in Seattle with WaMu executives. JPMorgan Chase offered WaMu \$8 a share, largely in stock but Mr. Killinger balked at the deal.

In April 2008, David Bonderman, a founder of the TPG private equity firm, and a group of institutional investors agreed to infuse \$7 billion of capital into the bank. Mr. Killinger kept his job, and Mr. Bonderman, who had served as a WaMu director from 1997 to 2002, returned with a board seat and 176 million WaMu shares priced at about \$8.75 each — steep discount of more than 25 percent to that day's share price. While the deal was good for Mr. Bonderman, it eroded the value for existing shareholders, enraging them. They moved on June 2 to strip Mr. Killinger of his chairmanship. Mr. Bonderman, meanwhile, watched his investment become worthless. Killinger was eventually replaced by Alan Fishman.

As of June 30, 2008, Washington Mutual Savings Bank had total assets of US\$ 307 billion, with 2,239 retail branch offices operating in 15 states, with 4,932 ATM's, and 43,198 employees. It held liabilities in the form of deposits of \$188.3 billion, and owed \$82.9 billion to the Federal Home Loan Bank, and had subordinated debt of \$7.8 billion. It held as assets of \$118.9 billion in single-family loans, of which \$52.9 billion were "option adjustable rate mortgages" (Option ARMs), with \$16 billion in subprime mortgage loans, and \$53.4 billion of Home Equity lines of Credit (HELOCs) and credit cards receivables of \$10.6 billion. It was servicing for itself and other banks loans totaling \$689.7 billion, of which \$442.7 were for other banks. It had non-performing assets of \$11.6 billion, including \$3.23 billion in payment option ARMs and \$3.0 billion in subprime mortgage loans.

On September 15, 2008, the holding company received a credit rating agency downgrade, from that date through September 24, 2008, customers withdrew \$16.7 billion in deposits, which ultimately led the Office of Thrift Supervision to close the bank. The FDIC then sold most of the bank's assets and liabilities, including secured debt to JPMorgan Chase for \$1.9 billion. Claims of the subsidiary bank's equity holders, senior and subordinated debt (all primarily owned by the holding company) were not acquired by JP Morgan Chase. Fishman who was in the job for only 17 days was guaranteed \$11.6 million as severance pay on top of the \$7.5 million signing bonus he got for taking the job.

Washington Mutual, with \$307 billion in assets, is by far the biggest bank failure in US history, eclipsing the 1984 failure of Continental Illinois National Bank and Trust in Chicago, an event that presaged the savings and loan crisis.

In subsequent court documents, WaMu insiders said the company's risk managers, the "gatekeepers" who were supposed to protect the bank from taking undue risks, were ignored, marginalized and, in some cases, fired. At the same time, some of the bank's lenders and underwriters, who sold mortgages directly to home owners, said they felt pressure to sell as many loans as possible and push risky, but lucrative, loans onto all borrowers. (<http://abcnews.go.com/TheLaw/story?id=6021608&page=1> November 17, 2008)

CASE 4: *Superior Bank*

The Pritzkers, one of the nation's wealthiest families and heirs to the fortune created by the Hyatt hotels, and Alvin Dworman, a New York real estate developer, formed a partnership with about \$44 million to take control of the insolvent Lyons Savings Bank in 1988 (with assistance from the former Federal Savings and Loan Insurance Company (FSLIC)). They renamed the bank Superior, moved it into subprime lending and saw the value of the bank soar in the late 1990's. It was one of the most aggressive financial institutions in the US and held over \$2 billion in assets before its collapse.

Superior was based in Illinois and regulated by the Office of Thrift Supervision (OTS). During the first years of operation it was severely limited in its activities as it concentrated on resolving problem assets. By 1992 Superior had improved the quality of its assets; it subsequently acquired a mortgage-banking subsidiary, Alliance Funding Company, and rapidly expanded its mortgage business. At this time sub-prime lending was on the increase and Superior was making sub-prime loans, securitizing them and retaining the 'residuals' on its balance sheet. When these loans are securitized they are divided into tranches (layers). The top tranche may be rated AAA, the next AA and so on, all the way down to the most risky 'equity' tranche. The cash flows from the equity tranche are known as residuals because they receive the last cash flows from the loans.

By 1999 the regulators had serious concerns about the concentration and the valuation of residuals on Superior's balance sheet. But the institutions and Fitch, which had rated Superior's long-term debt an investment grade BBB, did not see a problem. During 2000 Superior was directed by the OTS to increase capital or reduce the risk inherent in the institution's operations. The board of directors of Superior was subsequently sent a notice of deficiency, requiring the following actions:

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

In July 2000 Superior ceased securitizing loans and instead sold newly originated loans to its holding company CCFC which owned 100% of the thrift. It engaged the auditors Ernst and Young to assist in valuation of the residuals. Superior had also developed a plan to transfer the residual assets to CCFC. It terminated its sub-prime automobile lending business and established adequate loan loss reserves. It continued to originate loans, sell them to CCFC, with the servicing of the loans being performed by Superior.

Later in 2000 significant problems emerged. Superior had not responded to all the regulators' (OTS and FDIC) requests and there were significant errors in the financial statements and the accounting treatment of the residuals, resulting in their value being considerably overstated. Combined with other valuation adjustments, the examiners estimated an appropriate write-down of the residual assets might exceed \$200 million. Nevertheless in 2000 the auditors Ernst and Young gave Superior a relatively clean bill of health even though with hindsight, the bank was sliding into insolvency.

But by this time uninsured depositors had started to bail out. “The Thrift Financial Report submitted by Superior Bank to the Office of Thrift Supervision (and available on the FDIC’s Web site at www2.fdic.gov/call_tfr_rpts/?catNumber=74) indicates that Superior had uninsured deposits of \$572.4 million at its peak in March 2000 (schedule SI). This figure dropped to \$492.0 million in September, to \$253.6 million in December, and to \$52.6 million by March 2001.”²

On July 27 2001 the OTS appointed the FDIC as conservator and receiver and made the following statement.

“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 record keeping and accounting, and ineffective board and management supervision.”

Professor George Kaufman of Loyola University Chicago stated in the US Senate Committee that “[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 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 three years between yearend 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 1980s, 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 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 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. 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.”

² Eisenbeis, R. and L. Wall. “Reforming Deposit Insurance and FDICIA”, Federal Reserve bank of Atlanta Economic Review, First quarter 2002.

Subsequent to Superior's failure the Pritzkers agreed in December 2001 to pay the federal government \$460 million to avoid being punished for the failure of the bank (and to protect the reputation of Pritzkers). The agreement is the largest settlement with banking regulators since 1992, when Drexel Burnham Lambert, Michael R. Milken and about 40 other institutions agreed to pay about \$1 billion to settle allegations that they persuaded savings and loans to buy high-risk junk bonds with federally insured deposits, helping to accelerate the industry's collapse. The payment was to be spread over 15 years and would ameliorate the estimated cost to the government of \$1 billion. The Pritzkers also agreed to cede 90 percent of any money recovered in separate litigation to the government.

Federal subsequently regulators filed suit against Ernst and Young in November 2002 seeking more than \$2 billion in damages. "The Federal Deposit Insurance Corporation (FDIC), which insures bank depositors, is seeking some of the largest damages it has ever sought by filing suit against Ernst & Young. Regulators said they were looking for \$548 million in compensatory damages and triple that, or about \$1.6 billion, in punitive damages -- about \$2.2 billion altogether. Federal regulators have also faced criticism from lawmakers and industry experts for failing to detect problems at Superior, which had more than \$2 billion in assets when it was closed."³ The eventual cost to FDIC of Superior's failure was reported to be \$700 million and Ernst and Young agreed to pay \$125 million to FDIC in December 2004, but did not admit any liability.⁴ Under their original agreement with the regulators the Pritzker family received 25 percent of the payment from Ernst and Young.

³ <http://query.nytimes.com/gst/fullpage.html?res=9506E2DF173EF931A35752C1A9649C8B63> (accessed 17.11.08)

⁴ <http://www.nytimes.com/2004/12/25/business/25audit.html> (accessed 17.11.08)

Failed Bank Information : <http://www.fdic.gov/bank/individual/failed/superiorbalsheet.html>

Superior Bank, FSB - Receivership Balance Sheet Summary (Unaudited)

Fund Code: 6004
Failure Date: 07/27/01

**For Period Ending September 30, 2008
(in \$000's)**

Assets	Current Balance	Proven Deposit Claims	Claim Balance	%
Cash / Investments	\$ 66,900	FDIC Subrogated	\$	
Assets in Liquidation	218,744	Claim	1,556,516	97%
Estimated Loss on Assets in Liquidation ⁽¹⁾	<u>(35,992)</u>	Uninsured Depositors	<u>53,982</u>	<u>3%</u>
Total Assets	<u>\$ 249,652</u>	SubTotal - Proven Deposit Claims	\$ 1,610,498	100%
		Less: Dividends Paid to Date	<u>1,121,647</u>	<u>70%</u>
		Total Unpaid Deposit Claims	<u>\$ 488,851</u>	30%
Liabilities	Current Balance	Other Claimants	Claim Balance	%
Administrative Liabilities	\$ 90,829		\$	
FDIC Subrogated Deposit Claim	472,475	General Creditor	41,414	100%
Uninsured Deposit Claims	16,376	Subordinated Debt Holders	<u>0</u>	<u>0%</u>
Other Claimants	41,414	SubTotal - Other Claimants	\$ 41,414	100%
Liabilities at Inception - Unproven	<u>25,165</u>	Less: Dividends Paid to Date	<u>0</u>	<u>0%</u>
Total Liabilities ⁽²⁾	\$ 646,259	Total Unpaid Other Claimants	\$ 41,414	100%
Net Worth (Deficit)	<u>(396,607)</u>			
Total Liabilities and Net Worth	<u>\$ 249,652</u>			

In the Wall Street journal in July 2008, federal regulators who had blamed lenders for the sub-prime mess, were themselves accused of continuing to write sub-prime mortgages in the months after they took over day-to-day supervision of Superior, and were looking for a buyer for the bank.

This case study draws on testimonies to the U.S. Senate Committee on Banking, Housing and Urban Affairs. http://banking.senate.gov/01_09hrg/091101/seidman.htm
