Office of Inspector General

September 13, 2004
Report No. 04-035

Repurchases of Superior Federal, FSB, Loan Assets Sold to Beal Bank

AUDIT REPORT

TABLE OF CONTENTS

FDIC
Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20434-0002

Office of Audits
Office of Inspector General

DATE: September 13, 2004

MEMORANDUM TO: Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Repurchases of Superior Federal, FSB, Loan Assets Sold to Beal Bank*
(Report No. 04-035)

This report presents the results of the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's (OIG) audit of repurchases of Superior Federal, FSB (New Superior) loan assets. The audit objective was to determine whether the Division of Resolutions and Receiverships (DRR) adequately (1) prepared loan sale cases, (2) developed loan sales agreements, (3) conducted due diligence, and (4) processed loan sale repurchases related to the sales of New Superior loan assets. The audit focused on loan sale transactions executed between New Superior and Beal Bank (Beal). Additional details on our objective, scope, and methodology are provided in Appendix I.

BACKGROUND

On July 27, 2001, the Office of Thrift Supervision (OTS) closed Superior Bank, FSB (Old Superior) and named the FDIC as receiver[1] for the failed institution. Concurrently, the OTS chartered a new institution, New Superior, and appointed the FDIC as conservator[2] to operate the institution. The New Superior conservatorship operated from July 27, 2001 until May 31, 2002. At inception, New Superior had assets valued at about $2 billion that included residential fixed- and adjustable-rate mortgage loans.

As authorized in an FDIC Board of Directors resolution dated July 25, 2001, a Chief Executive Officer was hired to run New Superior's operations. In addition, a senior DRR official was named as chairman of the New Superior Board of Directors, and other DRR employees held prominent roles in overseeing the day-to-day operations of New Superior. New Superior

[1] The FDIC acts as a receiver for failed insured depository institutions. As receiver, the FDIC is charged with winding up the affairs of failed institutions, including the liquidation of failed institutions and the disposition of their assets. The FDIC also acts as the primary federal regulator for state nonmember banks. All FDIC business activity reviewed in this audit was undertaken by the FDIC in its receivership capacity.

[2] A conservator is a person or entity, including a government agency, appointed by a regulatory authority to operate a troubled financial institution in an effort to conserve, manage, and protect the troubled institution's assets until the institution has stabilized or has been closed by the chartering authority.

maintained its loan origination and loan servicing operations in order to maximize the value of the two business lines. New Superior continued to originate loans and sell them in sales initiatives to fulfill existing contracts with loan purchasers such as First Boston, Merrill Lynch, and Countrywide. These sales initiatives were referred to as Forward Sales. The FDIC funded about $750 million in new loans under existing business lines while marketing New Superior for sale.

Within the FDIC, DRR has primary responsibility for resolving failed FDIC-insured depository institutions promptly, efficiently, and responsively in order to maintain public confidence in the nation's financial system. Various DRR operating units share in this responsibility. Specifically, DRR's Franchise and Asset Marketing Branch (FAMB) is responsible for resolving troubled financial institutions and for selling the assets of failed institutions at the least cost to, and highest recovery for, the FDIC's insurance funds. FAMB's Asset Marketing Department (Asset Marketing) is responsible for pooling, marketing, and selling loans received from failed financial institutions. Finally, the Asset Claims Unit (Asset Claims) in DRR's Receivership Operations Branch is responsible for determining a suitable resolution for all asset claims.[3]

As previously stated, the FDIC operated New Superior as a conservatorship. The FDIC's policies regarding the operations of a conservatorship are contained in DRR's *Bridge Bank Manual*, revised May 24, 2004,[4] and provide the FDIC with flexibility in managing conservatorship operations in order to best serve the banking needs of the local community, operate the institution conservatively, and preserve its franchise value. The *Bridge Bank Manual* calls on the board and management of the conservatorship to operate it at the least cost to the FDIC's insurance funds and to exercise prudence in managing conservatorship assets. In addition, with respect to asset liquidation, the manual states:

> As overseers FDIC staff must carefully review applicable asset management and disposition policies, and avoid those that may be counter-productive to the operation of an open institution. . . . DRR oversight personnel must remain cognizant of the inherent differences in liquidating failed institution assets versus managing and operating an open institution.[5]

The *Bridge Bank Manual* states that FDIC policy directives should be considered in formulating bridge bank policies so long as they do not interfere with or detract from the operations of the ongoing institution. The manual also notes that many DRR directives deal with the liquidation of failed institution assets rather than the operation of an open institution and states that, when it is unclear if specific directives should be followed, FDIC staff should be consulted for guidance.

Other DRR policy and procedures referencing the management and liquidation of assets are contained in DRR's *Asset Disposition Manual* (ADM). Further, DRR's *Asset Claims*

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[3] Asset claims arise from contractual obligations under sale agreements made with purchasers of loans and loan-related assets.

[4] A bridge bank is similar to a conservatorship except that a bridge bank results in a new national bank chartered by the Office of the Comptroller of the Currency.

[5] The OIG took these inherent differences into account in performing, and reporting on the results of, this audit.

Administration Procedures Manual defines policies, identifies tasks, and assigns responsibilities necessary to manage, process, and report on claims.

During the conservatorship period, New Superior sold residential mortgage loans to Beal through three separate sales.[6] The book value of these loans totaled about $367 million, and proceeds from the loan sales totaled about $339 million. Table 1 provides details on the three sales.

Table 1: Mortgage Loan Sales to Beal

Sale Type	Number of Loans Sold	Book Value	Sales Proceeds	Bid Percentage
Scratch and Dent I*	801	$57,418,648	$54,467,111	93%
Scratch and Dent II*	608	43,020,399	31,624,051	72%
Final Sale*	3,906	267,042,221	252,965,401	93%
Totals	**5,315**	**$367,481,268**	**$339,056,563**	**92%**

Source: DRR spreadsheet of New Superior loan sales.
*The sales and loans are discussed below.

DRR Asset Marketing conducted the first two sales of subperforming and nonperforming[7] loans, referred to as Scratch and Dent I (November 6, 2001) and Scratch and Dent II (March 13, 2002). Asset Marketing prepared the cases recommending the sales, and the New Superior Board of Directors approved the cases. The third sale, the Final Sale (April 23, 2002), was conducted by HanoverTrade, a contractor under the oversight of Asset Marketing. The sales were executed through agreements between New Superior and Beal. These agreements contained certain representations and warranties (R&W)[8] as well as other provisions for loan sale repurchases that the seller, New Superior, gave to the purchaser, Beal, with respect to each mortgage loan. Taken together, the agreements, R&Ws, and provisions for the repurchase of loan assets specify the circumstances under which Beal could require New Superior to cure, substitute, or repurchase loans that did not meet certain requirements. (For the purpose of this report, the term R&W also pertains to other "provisions for repurchase" as identified in Appendix II.)

[6] New Superior conducted loan sales to purchasers other than Beal during the conservatorship period; however, such sales were not the subject of this audit.
[7] A subperforming loan is one in which the borrower is making reduced payments consistent with historical financial statements or is presently performing but is projected to ultimately default on the loan due to a future severe negative event. A nonperforming loan is one that is 60 or more days past due or is past the note or modification maturity date, regardless of whether ongoing payments are being received from the borrower.
[8] R&Ws and other provisions for repurchase can be offered in conjunction with loan sale offerings. The R&Ws promise to cure, substitute, or repurchase loans found to be in violation of certain requirements. (Such requirements include, for example, proper documentation, accurate loan amounts, and correct loan-to-value ratios.) As an example of an R&W or other provision for repurchase, the seller may be required to reimburse the purchaser for tax penalties and interest in the event tax returns were not filed and/or tax payments were not made as represented by the seller.

RESULTS OF AUDIT

DRR made a business decision to sell New Superior mortgage loan assets to Beal using Loan Servicing Agreements (LSA) consistent with those used at Old Superior. These LSAs contained R&Ws that were more comprehensive than the R&Ws generally offered in the standard FDIC LSA. In establishing its disposition strategy, DRR elected to rely on its knowledge of, and familiarity with, New Superior's loan origination operation and limited the extent to which it performed due diligence[9] on the loans included in the sales to Beal. Although this approach complied with policy, DRR could have better explained and justified its strategy in the loan case memoranda,[10] including the nature of the deviations from the standard LSA, the potential impact of the LSAs on repurchase claims, and the support for the decision to limit due diligence.

Subsequent to the loan sales, Beal filed and the FDIC has processed 1,098 asset repurchases claims totaling $56 million. DRR suspended the processing of additional Beal asset repurchase claims totaling about $39 million. Beal filed a lawsuit against the FDIC related, in part, to the repurchase claims. DRR has retained a contractor to perform due diligence to determine the value of assets at the time of the original sale. In essence, due diligence is being performed after rather than before the asset sale. As a result, the final settlement between the FDIC and Beal could significantly reduce the FDIC's reported recovery rate for the sales transactions (see Finding A: Sales of Mortgage Loans).

With respect to DRR's processing of Beal's claims for loan repurchases, we found that DRR processed the 12 Beal repurchase claims we reviewed in accordance with policies and procedures. For each repurchase claim submitted, DRR reviewed the accompanying support to determine whether the LSA had been breached and made a determination that was supported and communicated to Beal. If a breach had occurred, DRR accepted the claim and repurchased the loan. If a breach had not occurred, DRR denied the repurchase claim. DRR's decisions to accept or deny the 12 claims were adequately supported by sufficient evidence to justify the decision, and the decision appeared reasonable (see Finding B: Processing of Loan Repurchase Claims).

We are recommending that revisions be made to DRR's *Bridge Bank Manual* to improve procedures related to conducting loan due diligence and for explaining and justifying asset disposition strategies.

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[9] Due diligence is a review of pertinent files so that informed decisions can be made about the value of the failed institution's assets.

[10] A loan sale case memorandum is prepared to seek authority from the conservatorship Board of Directors to hold the sale under the terms and conditions in the memorandum.

FINDINGS AND RECOMMENDATIONS

FINDING A: SALES OF MORTGAGE LOANS

DRR made a business decision to sell New Superior mortgage loan assets using LSAs and an overall disposition strategy that were not fully justified in loan case memoranda. The LSAs involved R&Ws typical of those used at Old Superior and that were more comprehensive than those used for other FDIC asset sales. DRR relied on New Superior's loan origination and servicing operation and, therefore, limited due diligence activities in support of the sales. As a result, DRR has repurchased loans sold to Beal and has received asset claims for repurchases totaling about $96 million (28 percent) out of $339 million in New Superior loans sold to Beal.[11] Beal's claims were based on alleged breaches of the R&Ws in the LSAs. The FDIC has repurchased about $11 million in loans sold to Beal and has spent about $350,000 to process asset claims. Additionally, as a result of a lawsuit filed by Beal, the FDIC has spent about $200,000 to resolve matters with Beal, and legal costs are still mounting. Further, the FDIC could pay as much as $770,000 for contractor services for due diligence work being performed after the asset sales.

Repurchase of Loans From Beal and Lawsuit

New Superior sold about 5,300 mortgage loans for $339 million in 3 sales: Scratch and Dent I (S&D I), Scratch and Dent II (S&D II), and the Final Sale. The two S&D sales were conducted by DRR Asset Marketing, and each sale had an LSA. A financial services contractor conducted the Final Sale using two LSAs.

In early 2002, shortly after the S&D I sale closed, Beal began to submit asset repurchase claims to the FDIC, asserting that certain purchased mortgage loans breached the R&Ws in the LSAs. For example, Beal alleged that New Superior sold loans that contained predatory lending[12] violations; loans with errors in the reported loan-to-value[13] information; and loans with documentation problems, such as missing property title policies. According to DRR, predatory lending violations represented a significant percentage (76 percent) of the accepted claims.

DRR's Asset Claims began to review the claims and make decisions on whether to accept or deny the claims. As of January 22, 2004, Asset Claims had made determinations on 1,098 claims totaling $56.4 million. Of that amount, Asset Claims accepted about $11 million in repurchase claims and denied the remaining $45.7 million in claims (see Table 2). Based on DRR's 2003 recommended billing rates for processing asset claims, we estimated that it has cost the FDIC about $350,000 to process the 1,098 claims Beal has submitted (1,098 claims at $315 per claim).

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[11] Additional claims could occur because, as discussed later, Beal agreed to temporarily cease submitting claims.
[12] Predatory lending is an umbrella term generally used to describe cases in which a broker or originating lender takes unfair advantage of a borrower, often through deception, fraud, or manipulation, to make a loan that contains terms that are disadvantageous to the borrower.
[13] Loan-to-value refers to a comparison of the amount owed on a mortgaged property to its fair market value.

Table 2: Loan Repurchase Claims From Sales to Beal

Sale Date	Number of Claims	Amount Submitted	Amount Accepted	Amount Denied
November 6, 2001	565	$31,468,637	$ 5,878,780	$25,589,857
March 13, 2002	283	13,954,610	1,290,220	12,664,390
April 23, 2002	250	11,037,732	3,621,670	7,416,062
Totals	**1,098**	**$56,460,979**	**$10,790,670**	**$45,670,309**

Source: DRR spreadsheet of approved and denied loan repurchase claims from New Superior sales to Beal.

When the FDIC accepts a repurchase claim from a buyer, the FDIC pays cash for the returned assets. According to the Legal Division, repurchase claims are treated as administrative claims in a receivership with priority over other claims. To assure that funds will be available to pay such claims, the FDIC establishes a reserve for losses. Therefore, the Beal repurchase claims, like other repurchase claims, will be paid in cash. [redacted]

In October 2002, Beal filed a lawsuit against the FDIC relating to the S&D I sale to compel the FDIC's acceptance of repurchase claims. (Although Beal's lawsuit includes only the S&D I sale, the Legal Division expects Beal to incorporate the S&D II and Final Sale transactions into the lawsuit.) Subsequently, the FDIC established a "tolling agreement" with Beal, under which Beal agreed to cease submitting claims.[14] Specifically, the FDIC stopped making determinations on 607 claims (totaling about $39 million), which Beal had submitted before the tolling agreement was established. Based on the FDIC Legal Division's 2003 budget estimate related to receivership litigation, we estimated that it has cost the FDIC $198,828 for Beal-related legal issues (1,052 attorney hours at $189 per hour).

To assist in its defense against the Beal lawsuit, the FDIC hired a contractor to evaluate the New Superior loans held by Beal. The contractor is primarily tasked with performing due diligence to determine whether, at the time of the sales, the loans were in compliance with the R&Ws in the respective LSAs. Based on its loan reviews, the contractor is also to determine the cumulative loss to which Beal may be entitled. The contract price is capped at $770,000.

Loan Sale Agreements and Sale Case Memoranda

The LSAs used for both S&D sales and the one from the Final Sale varied substantially from the standard FDIC LSA – that is, the standard R&Ws – in effect at the time of the sales. Specifically, under the FDIC's standard LSA, all loans are typically sold "as is and with all faults," and the LSAs contain limited provisions for repurchase, including a 180-day restricted period after which a claim cannot be filed. However, the two LSAs from the S&D sales and one LSA from the Final Sale were patterned after LSAs used by Old Superior, which contained more

[14] In this context, "tolling agreement" refers to an understanding that suspends the time limitations for filing claims under the contract.

comprehensive[15] R&Ws relating to the condition and documentation of the loans. However, the LSAs did not include R&Ws related to loan performance. In addition, the Beal agreements were "open ended" or without a restricted period for submitting claims. Appendix II has details on the R&Ws in each LSA.

DRR's ADM states that when a nonstandard FDIC LSA is used to conduct a loan sale, the loan sale case memorandum should fully explain and justify all deviations from the standard LSA, specifically, deviations from the standard R&Ws. Although the *Bridge Bank Manual* does not incorporate the ADM by specific reference, the circumstances surrounding the sales to Beal support that deviations from the standard LSA should have been fully explained and documented.[16] However, the New Superior loan sale case memoranda for the S&D sales had no explanation or justification for the use of a loan sale transaction structure that differed from the standard FDIC LSA. The case memoranda stated that ". . . reps and warrants offered in this sale are typical of those previously used by Superior Bank, FSB, in the sub-prime scratch and dent market . . . ." The FDIC did not prepare a sale case memorandum for the Final Sale; rather, the Final Sale was authorized by the FDIC Board of Directors in a resolution[17] subsequently adopted by New Superior's Board of Directors. Similarly, the FDIC Board of Directors' resolution did not explain or justify deviations from the standard FDIC LSA.

DRR's Asset Disposition Policy Memorandum 99-01, *Revised Loan Sales Bid Package*, dated December 20, 1999, provides reasons for, and guidance on, the use of a standard LSA. First, the memorandum states that standard loan sale documents contribute to a more efficient marketing and asset claims process, reduce the likelihood of disputes, minimize administrative costs, and tend to enhance credibility in the market. The memorandum also states that the Deputy Director, FAMB, or designee, must approve modifications to the standard LSA and bid package documents. Further, the memorandum requires that proposed modifications, with business and legal justifications, were to be submitted for FAMB approval through the assigned FDIC Legal Counsel.

When we asked about the deviations from the FDIC's standard LSA, DRR officials forwarded copies of electronic mail (e-mail) messages to us as evidence that the use of the R&Ws in the LSA for the S&D I sale was fully explained and justified to the New Superior Board of Directors in lieu of a discussion in a loan sale case memorandum. Our summary of one e-mail addressed to the Legal Division and copied to DRR managers—including the Chairman of the New Superior Board of Directors—follows:

> The FDIC is able to repurchase any loan found to be in violation of any statute that could represent an instance of predatory lending. The underlying loan documents used for the S&D sale have

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[15] The R&Ws are detailed in Appendix II and show that the R&Ws offered by New Superior were more comprehensive in that they provided greater protection to the purchasers of the loans.

[16] *Management of Assets,* an August 23, 2002 lessons learned article regarding New Superior by DRR managers, acknowledges that it … "is the inherent FDIC responsibility to direct all sales according to DRR asset disposition policies and procedures and the belief that such responsibility should not be superceded by the form of FDIC control over a bank, whether Conservatorship or Receivership."

[17] An FDIC Board of Directors Resolution, dated December 20, 2001.

> previously been used by New Superior for such a sale and are representative of the industry standard for such a sale. DRR has done all that can reasonably be done to make these documents the best possible for this transaction. Once the New Superior Board of Directors approves the case, DRR is ready to announce the sale and distribute the documents to prospective purchasers.

We found that the e-mails were not circulated to all members of the New Superior Board. Additionally, the e-mails did not explain the reasons for, or benefits of, approving the sale using the nonstandard LSA with the comprehensive R&Ws. Finally, the messages did not provide the basis of DRR's statement that the R&Ws represented the industry standard. Accordingly, we concluded that DRR had not fully explained and justified deviations from the standard LSA.

DRR officials also stated that they structured the loan sales transactions with more comprehensive R&Ws because former Old Superior employees stated that repurchases of loans under the repurchase provisions contained in the Old Superior LSA were primarily due to loan performance problems and that DRR had excluded such performance-based R&Ws from the LSAs. However, there is no evidence that the DRR officials independently verified or corroborated that Old Superior loan repurchases were mainly the result of loan performance problems.

DRR cited the extensive and thorough process that New Superior followed in the consideration of R&Ws and the development of LSAs for the Forward Sales as evidence of their consideration and development of LSAs for the S&D I and II sales to Beal. DRR maintains that the R&Ws used on the S&D loan sales were a "scaled backed" version of those used with the Forward Sales LSAs. We reviewed the well documented R&W development effort for the Forward Sales LSAs but had difficulty establishing a direct link to the S&D sales because the supporting documentation did not clearly tie together the two sales initiatives. Moreover, the S&D sales to Beal differed substantially from the DRR's Forward Sales effort, which involved performing loans sold by conservatorship staff under existing letters of commitment from prior buyers for the specific purpose of preserving the value of the loan origination operation until a buyer could be found. Conversely, the Beal sale was the sale of loans with prior delinquencies and/or loans that had fallen out of previous sales for various reasons and that have been specifically given to Asset Marketing because it was better equipped, with an extensive database of buyers of distressed loans, to manage the sale.

Due Diligence

DRR Asset Marketing staff performed limited loan due diligence during the preparation for the S&D sales and performed no due diligence for the Final Sale. According to DRR loan liquidation policies, the purpose of performing due diligence during the loan packaging and pre-pricing process before a loan sale is to minimize repurchase requests in order to serve the best administration and public relations interests of the FDIC.

Based on our review of the loan sales files and our discussions with DRR officials, we found that DRR performed limited due diligence during the packaging process when loans that met repurchase provisions in the LSA were to be identified and removed from the sale. Specifically, DRR focused its due diligence efforts on predatory lending issues. DRR was also concerned with ensuring that the loans were legally collectible and that there was no ongoing litigation that could impair the enforceability of the loans. DRR did not, during its pre-pricing of loans for the S&D sales, review each loan file to determine whether all pertinent documentation was in the loan file nor did DRR personnel document their file review procedures in the sales files. According to a DRR official familiar with these sales, the DRR staff did not have time to review each file for pertinent information.

According to DRR, a complete file review was not necessary because New Superior had a comprehensive subprime mortgage loan pipeline origination and sales operation based in Orangeburg, New York, under DRR's supervision. DRR stated that this operation had a process to ensure that loan applications were underwritten according to New Superior guidelines and a quality control function as an additional compliance check. DRR considered that this ongoing conservatorship operation effectively conducted the needed due diligence and was the reason due diligence activities of DRR's Asset Marketing staff were limited.

We disagree with DRR's position for several reasons. First, the S&D I loans were originated and underwritten prior to the FDIC conservatorship. Therefore, DRR was not overseeing the loan origination and sales operation when the loans were originated. Second, many of the S&D loans were originally part of previous Old Superior loan sales and were returned for various reasons, including loans that were nonperforming. Therefore, New Superior's loan origination operation was not an adequate substitute for DRR's own due diligence on this loan portfolio because of the age and impaired nature of the loans. In essence, the potential exists that subsequent information could have been considered in deciding on the R&Ws to be offered in the loan sales. Finally, despite the fact that both New Superior's loan origination operation and DRR's limited due diligence focused attention on preventing the sale of loans with potentially predatory terms, DRR Asset Claims accepted 200 Beal claims for repurchases because they violated predatory lending policies.[18]

Conclusion and Recommendations

DRR made a business decision to sell New Superior mortgage loan assets to Beal using R&Ws that were more comprehensive than the R&Ws generally offered in the standard FDIC LSA. Further, instead of performing the type of due diligence that would be required under the ADM for the sales of receivership assets, DRR elected instead to rely primarily on controls in place at New Superior. Based on the results of our audit, the FDIC may benefit from DRR conducting a

[18] In response to anecdotal evidence about abusive practices involving home-secured loans with high rates or high fees, in 1994, the Congress enacted the Home Ownership and Equity Protection Act (HOEPA) as an amendment to the truth in lending Act (TILA). TILA requires creditors to disclose the cost of credit as a dollar amount (the "finance charge") and as an annual percentage rate (the "APR"). TILA requires additional disclosures for loans secured by a consumer's home and permits customers to rescind certain transactions that involve their principal dwelling.

more thorough cost-benefit analysis of the need to follow DRR asset disposition policies and procedures when liquidating assets and more fully documenting and communicating the support for its decisions.

We recommend that the Director, DRR, revise the *Bridge Bank Manual* to require the boards of directors of bridge banks and conservatorships to:

(1) Ensure that loan due diligence be performed commensurate with the R&Ws and other provisions for repurchase offered in the LSA used for a loan sale transaction and that the level of due diligence and any decision to limit due diligence be fully explained and justified in loan sale case memoranda.

(2) Ensure that asset liquidation disposition strategies and assessments of the potential impact of LSAs on repurchase claims be fully explained and justified in loan case memoranda, particularly when the form of a transaction results in the use of a nonstandard FDIC LSA.

FINDING B: PROCESSING OF LOAN REPURCHASE CLAIMS

Our review of a sample[19] of 12 Beal repurchase claims indicated that DRR processed such claims in accordance with policies and procedures. For each of the 12 repurchase claims Beal submitted, DRR reviewed the documented support to determine whether the LSA had been breached and communicated the decision to Beal. If a breach had occurred, DRR accepted the claim and repurchased the loan. If a breach had not occurred, DRR denied the repurchase claim. DRR has denied about $46 million (80 percent) out of the $56 million in processed Beal claims. Beal has submitted $39 million more in claims that DRR has not addressed because of the tolling agreement. Our review of the 12 repurchase claims showed that the decisions to accept or deny the claims were adequately supported.

Analysis and Evaluation of Beal Claims

The analysis and evaluation of claims is a coordinated effort involving the claims processor, the claims analyst, the Asset Claims Administration (ACA) manager, and the Legal Division. DRR's *Asset Claims Administration Procedures Manual* defines the policies, identifies the tasks, and assigns the responsibilities necessary to process and report effectively on claims administration. The process begins once a purchaser notifies the seller of a claim. For each claim, the claims analyst determines the validity of each alleged deviation of the LSA and completes a claim review worksheet. If necessary, the claims analyst asks the Legal Division for advice, guidance, or a legal opinion related to an asset repurchase claim. Based on whether the claim criteria in the LSA have been met, the claims analyst decides whether to approve or deny the claim. The decision is agreed to by a second claims analyst and reviewed by the ACA manager. The ACA manager then sends a resolution letter to the claimant, indicating the reasons for acceptance or denial. Of the 12 sample claims reviewed, 5 claims were accepted, and 7 claims were denied. We agreed with the rationale for the decision to accept or deny these claims. Examples of some claims determinations follow:

- On February 27, 2003, Beal submitted a notice to the FDIC, asserting that Section 5(b)(19) of the November 6, 2001 Mortgage Loan Purchase Agreement had been breached. This section of the agreement provides a representation that each mortgage loan classified as a "high cost" loan under Section 32 of the HOEPA complies with all applicable rules with respect to disclosure. The threshold for a "high cost" loan is reached when points and fees exceed 8 percent of the total loan amount. Points and fees for this loan totaled $5,172, and the total loan amount was $62,807. Points and fees comprised 8.23 percent of the total loan amount. Thus, the loan was classified as "high cost" under HOEPA criteria. Failure to disclose this fact to the borrower represented a breach of the disclosure requirements in the Mortgage Loan Purchase Agreement. The FDIC determined that a breach had occurred and approved the asset for repurchase. The

[19] See Appendix I for more information regarding our sampling methodology.

FDIC's decision to repurchase the loan was adequately supported by its calculation of the percentage of points and fees in relation to the total loan amount and the criteria set forth in the Mortgage Loan Purchase Agreement.

- On October 20, 2003, Beal submitted a notice to the FDIC, asserting that Section 8 of the March 13, 2002 Mortgage Loan Purchase Agreement had been breached. This section of the agreement provides a representation that between the closing date and the transfer date, the seller shall service the mortgage loans in order to protect the purchaser's interest. In relation to this loan, the transfer of servicing did not take place until April 30, 2002, and Beal claimed that the interim servicer failed to protect Beal's interest. Beal claimed that collateral was lost due to a foreclosure sale conducted by a trustee. However, the foreclosure sale did not occur until after servicing of the asset was transferred to Beal. The FDIC determined that a breach had not occurred and denied the request for repurchase. The FDIC's decision to deny the repurchase was adequately supported by the determination that Beal did not demonstrate that the interim servicer failed to protect Beal's interest in the loan.

Because we determined that the FDIC's decisions to accept or deny the 12 repurchase claims were adequately supported, we did no further testing of other claims determinations, and we are making no recommendations related to the processing of repurchase claims.

CORPORATION COMMENTS AND OIG EVALUATION

We originally provided a draft of this report to DRR on May 28, 2004, and received comments from DRR on July 2, 2004. We made substantive revisions to the draft and requested a further response from DRR. On September 7, 2004, the DRR Director provided a written response to the revised draft report. The response is presented in its entirety as Appendix III of this report. Overall, DRR did not concur with the report's findings or recommendations. Specifically, DRR stated that the draft report and its recommendations do not consider, particularly for a bridge bank or conservatorship, that the facts and circumstances of an institution should be the primary driver in making business decisions and establishing documentation requirements.

Our report does consider the facts and circumstances surrounding New Superior, but our assessment of their impact on the FDIC's business decisions and documentation requirements differs from that of DRR. As discussed in more detail later in this section, DRR relied on former Old Superior employees and operations and experiences associated with prior Old Superior asset sales. However, the extent to which DRR assessed Old Superior's system of internal control associated with loan origination and servicing before relying on it was not clear from the case memoranda, New Superior Board of Directors minutes, or case files. The internal control structure should provide reasonable assurance that transactions are adequately supported, financial and other reports are reliable, and compliance with applicable laws and regulations is achieved. Lacking such an assessment, and considering that Old Superior was a failed institution and the assets being sold were considered impaired, use of the nonstandard LSA with R&Ws that were more comprehensive than those ordinarily offered by the FDIC may not have been commensurate with the risk associated with the sales transactions.

Our findings and recommendations focus on improving the analytical support and communication to a conservatorship's board of directors. We maintain that our recommendations are warranted and that implementing them will help ensure that sound, well-informed decisions are made regarding asset disposition strategies. For the most part, the additional support that DRR provided in its comments regarding the approach to the loan sale transactions was not brought to our attention in interviews nor did we find it in associated transaction documentation DRR provided to us during our audit. The key to our finding and recommendations is that the extent of analysis and support that DRR has now made available to us in its response, while still not adequate in our view, is the type of information one would expect to be presented to New Superior's Board of Directors at the time the transactions were approved. Taking into account the factors and information DRR now contends were considered, it is still our opinion that DRR did not conduct a sufficiently detailed analysis of the portfolio or perform adequate due diligence to determine whether the use of the LSAs, including the R&Ws, were appropriate to the assets or to assess the potential impact of such LSAs in the context of repurchase claims.

DRR also provided detailed comments on several issues related to the sales of assets to Beal. The comments and related OIG responses are provided below.

DRR Comments on the Audit

<u>Adequate Due Diligence</u>

DRR Comments:
DRR disagrees with the finding that there was inadequate due diligence to offer the R&Ws. According to DRR, it used a multifaceted approach to due diligence based on the facts and circumstances of the Superior conservatorship. DRR staff conducted Asset Valuation Reviews (AVRs) for the S&D loan sales. In addition, DRR factored New Superior's loan origination and servicing operations as well as actual R&W put-back experience from Old Superior's prior sales and put-back experience from Resolution Trust Corporation (RTC)[20] sales that offered market-typical R&Ws into its decision to continue Old Superior's practice of offering market-typical R&Ws. The FDIC, as conservator, employed New Superior underwriters, auditors, and servicing personnel. This staff effectively conducted ongoing due diligence of the loan portfolio, both in the origination process and its servicing department, under the supervision of the FDIC's appointed Chief Executive Officer, with oversight by DRR staff. DRR also noted that neither the U.S. Department of Treasury OIG in its Material Loss Review, the U.S. Government Accountability Office, nor the FDIC OIG cited Old Superior's underwriting or servicing operations as a contributing cause of its failure.

[20] The RTC's legislatively mandated sunset date was December 31, 1995. Responsibility for all RTC-related work as of that date was transferred to the FDIC in accordance with the *RTC Completion Act.*

OIG Response:
In our opinion, DRR performed only limited loan due diligence with respect to the S&D loan sales to Beal, and due diligence was not adequate given the nature of the Beal sales transaction. DRR contends that it employed a multifaceted approach to due diligence, including conducting AVRs. However, in this circumstance, the AVRs did not represent an adequate substitute for due diligence. First, the primary purpose of the AVR process is to establish an estimate of the value of an institution's assets, which is then considered as a minimum price the FDIC is willing to accept from potential purchasers of failing institutions, not to determine whether R&Ws are supported by particular loan files. Second, we question the comprehensiveness of the AVRs conducted. The OIG noted in a report entitled, *Least Cost Decision of Superior Bank and Liquidation of Remaining Receivership Assets* (Report Number 02-002, dated February 8, 2002), that because of incomplete information and insufficient time DRR did not complete an AVR that would enable DRR to solicit bids from potential acquirers of Superior. For this reason, Superior was placed in conservatorship rather than receivership. Third, according to the September 10, 2001 New Superior Board of Directors minutes for the S&D I sales case, the loans in question were evaluated by the FDIC AVR team prior to Old Superior's failure, a point in time before the development of the Beal LSA R&Ws. Therefore, the AVR team was not aware of the R&Ws to be included in the sale transaction when the team was doing its work, and the impact of the R&Ws could not have been reasonably assessed.

In earlier correspondence with the OIG, DRR maintained that as conservator the FDIC employed New Superior staff that operated a comprehensive subprime mortgage loan pipeline origination and sales operation, which, effectively, conducted the FDIC's due diligence on the loan portfolio as part of the underwriting process. DRR provided this reason for the limited due diligence activities of DRR Asset Marketing staff when compared to typical receivership loan sales. We understand that, in the mortgage loan pipeline origination process, underwriting serves a specific purpose. However, due to the age and impaired nature of these loans, underwriting performed at the time of loan origination may not ensure that loan documentation remains adequate up to the time the loans were sold. Additionally, underwriting may not, in and of itself, cover all the elements associated with the R&Ws added to a particular LSA for a loan portfolio sale. Also, the S&D I loans were largely underwritten before DRR was in control of the New Superior loan pipeline operation.

Concerning whether Superior's underwriting or servicing operations were contributing causes of its failure, in a FDIC OIG report entitled, *Issues Related to the Failure of Superior Bank, FSB, Hinsdale, Illinois* (Report Number 02-005, dated February 6, 2002), we reported that "[Office of Thrift Supervision] examiners stated that in 1999, the underwriting standards deteriorated in order to generate a greater volume of loans. Reportedly, Superior made efforts to tighten the lax standards in 1999; however, the increase in loan losses does not indicate that Superior was successful with this effort." The report also states that Old Superior's internal audit process was limited and that a solid internal control structure and risk management program were not in place at Old Superior. Accordingly, there was ample evidence to question reliance on Old Superior's internal control over loan processing.

Moreover, in assessing the adequacy of the due diligence performed, there are two other aspects of the loan sales to Beal that reinforce our position that the underlying support for these transactions was not sufficient. First, there was no DRR oversight of the loan origination and servicing operation during the period in which the S&D I loans were underwritten. As a result, the basis for DRR's claims about the sufficiency of this process is unclear. Second, although the sales to Beal took place out of a conservatorship, in our opinion, the FDIC puts its reputation at risk if due diligence is limited and assets are sold that do not meet the requirements of the sales agreements.

Use of R&Ws Adequately Supported by Case and Other Documentation

DRR Comment:
DRR disagrees that there was insufficient case documentation supporting the offering of the R&Ws in these sales. According to DRR, the New Superior Board of Directors approved the use of R&Ws at its August 16, 2001 Board meeting. A case written by DRR Asset Marketing staff requesting the use of market-typical R&Ws (*Modifications to Current and Future Loan Sale Agreements – Company and Individual Loan Representations and Warranties*) was presented to the New Superior Board. The case and its attachments included (1) documentation associated with the types of R&Ws Old Superior offered prior to conservatorship, (2) reviews by DRR and Legal Division staff, (3) discussions of the similarity of Superior's R&Ws to those RTC offered in its sales and their repurchase history, (4) discussions of the added value of offering market-standard R&Ws, and (5) the current subprime market standards for typical R&Ws. DRR claimed in its statement, "… with respect to the Equity One, First Boston and Countrywide transactions [i.e., the Forward Sales] *and all future sales with similar reps and warranties*. . . ." that there was adequate linkage established in the minutes of the meeting and the New Superior Board resolution that approved the use of market standard R&Ws. DRR also stated that the loans sold in all of New Superior's loan sales came from the same loan origination platform, and the S&D sales did not provide R&Ws for performance, only for their origination documentation and servicing.

OIG Response:
The New Superior Board of Directors approved the R&Ws for the Forward Sales at its August 16, 2001 Board meeting. However, evidence does not clearly show approval of R&Ws for the S&D I and II and Final sales efforts at this meeting. There was ample evidence with respect to the Forward Sales that DRR weighed the risk associated with the offered R&Ws against the opportunity to sell additional loans under the forward commitments. The use of the nonstandard LSAs and the subsequent R&Ws was fully explained and justified in the Forward Sales case, and all associated FDIC components (Legal, Asset Marketing, and Asset Claims) formally approved the use of the R&Ws. The supporting documentation was thorough and well defined. Overall, the Forward Sales efforts were consistent with FDIC policies and procedures, particularly the requirements of the ADM.

With respect to DRR's sales of the S&D loans, DRR Asset Marketing was chosen to manage the sale because of its expertise in handling and liquidating these types of loans (which were of a distinctly poorer quality than loans in the Forward Sales). When we interviewed DRR Asset

Marketing officials and reviewed the S&D sales files, we did not find support that justified or explained the use of the nonstandard LSA and R&Ws. In this regard, there were distinct differences between the Forward Sales described above by DRR and the S&D loan sales. For example, the sales files did not contain a record of the file review procedures. Further, the e-mails or working papers that DRR provided as attachments to its written response also show that the R&W development process for the S&D loans was a quick process of adopting the same R&Ws from the Old Superior sale of similar types of loans held on June 26, 2001, shortly before that institution was closed. The working papers suggest that information was shared but do not fully justify and explain the use of a nonstandard LSA.

In responding to the OIG draft report, DRR management referenced the Forward Sales efforts information as documentation to justify and/or explain the S&D and Final sales. For example, DRR's assertion that the New Superior Board of Directors approved the use of R&Ws ". . . with respect to the Equity One, First Boston, and Countrywide transactions *and all future sales with similar reps and warranties"* as applicable to the S&D sales is taken out of its proper context. The August 16, 2001 Board minutes and the August 14, 2001 case requesting the use of the R&Ws clearly show that the sole focus of attention at that time was the Forward Sales initiative. The Board minutes do not make any reference to the S&D loans.

We had difficulty establishing a direct link between the R&W development effort for the Forward Sales to the S&D sales to Beal because the supporting documentation did not clearly tie together the two sales initiatives. It is our view that one portion of a sentence, ". . .*all future sales with similar reps and* warranties . . .," is not discernibly linked to the S&D sales effort. In fact, it would be a questionable practice on the part of the New Superior Board to provide such blanket approval for loan sale R&Ws without reviewing the underlying support. Even DRR agreed in its response letter that the individual sales case did not refer to the R&Ws blanket case. Moreover, the S&D sales files, the LSA case memoranda, and subsequent New Superior Board minutes for the Beal sale did not mention loan sampling or the fact that DRR Asset Marketing staff limited due diligence on these types of assets and elected instead to rely primarily on controls in place at New Superior. DRR should have followed a similar practice to that used for the Forward Sales.

Finally, our view remains unchanged that the S&D sales to Beal differed substantially from the DRR's Forward Sales effort, which involved performing loans sold by conservatorship staff under existing letters of commitment from prior buyers for the specific purpose of preserving the value of the loan origination operation until a buyer could be found. Conversely, the loans sold to Beal were poorer quality loans sold to a buyer that was not planning to resell the loans in the secondary market through a securitization. The S&D loans were specifically given to Asset Marketing because it was deemed better equipped, with its extensive database of buyers of distressed loans, to manage the sale.

Beal Bank Claims Not Viewed in Context of Total New Superior Repurchase Claims

DRR Comment:
According to DRR, by focusing only on the Beal sales, the OIG fails to put the three sales in the context of the total loan pipeline sale operation at the New Superior conservatorship. The report ignores the majority of loans New Superior sold and is solely focused on the sale of 5,315 loans to Beal. DRR gave significant consideration to the historical repurchase data that Superior kept with respect to repurchase activity concerning different sale transactions.

OIG Response:
We acknowledge that we did not perform an audit of all claims related to New Superior loan sales. In our reannouncement memorandum, dated December 17, 2003, we revised the audit objective to focus on the loan sale transactions executed between New Superior and Beal because of the higher risk to the Corporation associated with the large number of repurchase claims Beal filed. The Beal repurchase claims are specific to the nature of the loans, the sales effort, the conditions of sale, and the intended market. Our audit focused on our assessment of the loans sold to Beal, and we reported our results relative to that objective.

Beal Bank Results Not Differentiated or Correlated to R&Ws

DRR Comment:
According to DRR, the OIG provides no evidence to support any cause and effect between the New Superior LSA and Beal's claims. The original case approving the use of R&Ws showed that Superior had experienced a 5-percent approved claim rate prior to failure, and the Beal experience is not out of line with the claim rate. There is no analysis of the types of claims submitted, the types approved, or the types rejected. Additionally, the OIG provided no analysis of either the cost or benefit of conducting additional due diligence. The language in the R&W case and S&D sales cases, collectively, justifies and substantiates that the R&Ws offered were very similar to those used by the former bank and the industry.

OIG Response:
The cause and effect between the New Superior LSA and the Beal claims are evident from the results of the sales. The FDIC set the conditions of the sale and, through the LSA, provided Beal with the opportunity to submit claims for repurchase under R&Ws that were far more comprehensive than the FDIC's standard LSA. Moreover, DRR gave Beal an indefinite period in which to make the claims, unlike the standard 180-day period included in the standard LSA. Limiting this period would have been advantageous to the FDIC because associated liability is brought to closure at the end of the period. Concerning the approved claim rate, it is premature to conclude that the Beal experience is in line with that of Old Superior. Specifically, claims processing has been suspended for $39 million in claims submitted to date, the tolling agreement has resulted in Beal's ceasing to submit new claims, and Beal is litigating to compel acceptance of its repurchase claims. The factors could materially impact the financial outcome of these sales.

It is correct that the OIG did not analyze the cost of conducting additional due diligence. It serves no purpose for the OIG to do a cost-benefit analysis 2 years after the sales took place and it is not the proper role of the OIG in this case to attempt to find support for management decisions. Rather, DRR should have considered the cost or benefit of additional due diligence in preparation for the S&D I sale and developed the support for its position. Currently, because of a pending law suit, the FDIC hired a contractor to perform due diligence work on the New Superior loans held by Beal. The contractor was tasked with performing the due diligence to determine whether, at the time of sale, the loans were in compliance with the R&Ws in the respective LSAs. In our opinion, the FDIC is performing due diligence after-the-fact, that is, after the sale to Beal. The FDIC places its reputation at risk if it is not seen as operating a conservatorship in the most prudent manner, which in this case would have included better support for the LSAs.

The case memorandum addressing the LSA for S&D I (along with the associated R&Ws) does not contain language justifying and substantiating why it is advantageous to the FDIC for the proposed R&Ws to be offered in the sale. Rather, the case memorandum simply states that the proposed R&Ws are typical of those offered by Old Superior. Additionally, interviews conducted with Asset Marketing personnel during the audit indicated that no market research had been performed to determine how other sellers of similar loan products (S&Ds) were structuring sales transactions with respect to R&Ws. Without such research, it is unclear how DRR determined that the proposed R&Ws for S&D I were representative of similar R&Ws offered in the market place. When comprehensive R&Ws are part of the LSA, as was the situation with the Beal sale, they may enhance the price the buyer is willing to pay but depending on the appropriateness of the R&Ws, there is a shift in risk to the FDIC that it ordinarily does not assume. This transfer of risk should have been fully explained and justified.

Home Owners Equity Protection Act (HOEPA)

DRR Statement:
According to DRR, the OIG failed to distinguish between the HOEPA representations and the other representations. For public policy purposes, DRR did not want to sell loans with HOEPA violations to any buyer and attempted to discover these loans during the due diligence and packaging phase. DRR knew it would be expensive, difficult, and time consuming to attempt to find all of these loans, so the HOEPA provision was included in all the sales agreements to allow the FDIC to repurchase these loans. The rules for determining HOEPA loans are not always clear. In fact, a contractor hired by DRR to review the HOEPA loans that were repurchased found that 65 of the 159 loans DRR reviewed were not HOEPA violations. DRR also stated that the report characterized these loans as "predatory loans" and "violating predatory lending practices" without any supporting documentation.

OIG Response:
Our report states, "According to DRR, predatory lending violations represented a significant percentage (76 percent) of the accepted claims." In our opinion, this statement provided an adequate perspective of the HOEPA representations. Regarding DRR's comment that a contractor found that 65 of the 159 loans DRR reviewed were not HOEPA violations, subsequent

work by DRR's Asset Claims staff indicated that 60 of the 65 loans were, in fact, valid HOEPA claims. Finally, the OIG did not intend to suggest that either Old or New Superior engaged in predatory lending practices. In our report we state, " . . . despite the fact that both New Superior's loan origination operation and DRR's limited due diligence focused attention on preventing the sale of loans with potentially predatory terms, DRR Asset Claims accepted 200 Beal claims for repurchases because they violated predatory lending policies."

<u>Recommendations</u>

DRR Statement:
DRR disagrees with Finding A of the Report and its two recommendations. However, recognizing the importance of documenting business decisions, by September 30, 2004, DRR will amend Section 2A of the *Bridge Bank Manual* as follows: "The Bridge Bank Board of Directors should adopt policies for documenting business decisions and will distribute the policy to Bridge Bank management and to FDIC personnel working with the Bridge Bank."

OIG Response:
DRR did not conduct a sufficiently detailed analysis of the portfolio or perform adequate due diligence to (1) determine whether the use of these forms of agreements were appropriate to the assets, or (2) assess the potential impact through a cost-benefit analysis of such forms of agreement in the context of repurchase claims. Regardless of the FDIC's form of control over the bank, each of our recommendations addresses the need for DRR to provide senior FDIC managers with the information they need to make sound, well-informed decisions regarding asset liquidation. All asset liquidation efforts should include these sound business practices. Our position is that DRR should require that sufficient due diligence be conducted to support the R&Ws to be included in the LSAs. DRR should provide clear guidance on the applicable directives that govern each sales initiative whether for a bridge bank/conservatorship operation or a receivership. The Board of Directors should be fully informed of any deviations from the identified, appropriate liquidation guidance. The OIG has concluded that the report's recommendations have merit. Therefore, we consider the recommendations to be unresolved because the proposed corrective action by DRR is not sufficiently detailed to ensure that the intent of our recommendations is achieved. We request that DRR reconsider its position and provide additional written comments within 15 days.

OBJECTIVE, SCOPE, AND METHODOLOGY

The audit objective was to determine whether the DRR adequately (1) prepared loan sale cases, (2) developed loan sale agreements, (3) conducted due diligence, and (4) processed loan sale repurchases related to the sales of New Superior loan assets. The audit focused on loan sale transactions executed between New Superior and Beal.

The FDIC, as conservator, was responsible for the liquidation of New Superior assets and liabilities totaling over $2 billion. The conservatorship continued to maintain the depository base, the loan origination platform, and the servicing operation to maximize the value of the business line. The FDIC funded approximately $750 million in new loans under the existing business lines while New Superior was marketed. Subsequently, these assets were sold in an extensive nationwide sales effort. Our audit scope included the review of DRR's sale of mortgage loans from New Superior to Beal over the conservatorship period from July 21, 2001 to May 31, 2002. In all, New Superior sold Beal 5,315 loans for $339 million in 3 separate sales: Scratch and Dent I, Scratch and Dent II, and the Final Sale. Our work involved an analysis of the activities and events surrounding the four distinct LSAs for these sales transactions.

Methodology

To achieve the audit objective regarding whether DRR adequately developed the LSAs, we reviewed copies of each LSA for the three sales. We also reviewed a copy of the LSA used by the conservatorship for selling loans in process through forward contracts[21] and a copy of the LSA Old Superior had used for its own scratch and dent sales before it failed. We compared the terms and conditions of the various LSAs against the FDIC standard LSA applicable for the time period in which the sales were conducted, paying particular attention to the major provisions of each R&W section in the LSAs. We noted the chronological development of the LSAs for both the Forward Contract sales and the S&D sales and documented significant differences between the provisions in the LSAs. We reviewed the respective LSA sales case memorandum, if one had been prepared, to determine whether it included a full explanation and justification for the sections/provisions that differed. Finally, we verified whether the New Superior LSAs were prepared by the FDIC's Legal Division to ensure accuracy and applicability.

To determine the level or extent of due diligence performed on the New Superior loans, we interviewed DRR Asset Marketing officials and corresponded with the contractor hired to manage the Final sale. Additionally, we reviewed the Asset Marketing sales files for both the Forward Contract sales and S&D sales. We discussed the due diligence requirements in the ADM with Asset Marketing officials. Also, we discussed with the FAMB Deputy Director the New Superior mortgage loan pipeline origination and sales operation regarding due diligence activities as well as the requirements of the newly revised *Bridge Bank Manual.*

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[21] On the bank closing date, Old Superior had agreements in place to sell approximately $346 million in loans to four of its primary whole loan purchasers—DLJ/First Boston, Countrywide, Merrill Lynch, and Equity One. Authority was granted to the conservatorship staff to continue to sell loans into the forward contracts provided they were sold at the terms in place as of the bank closing date.

To determine whether DRR's Asset Claims Unit accurately processed Beal claims for repurchases, we judgmentally selected 12 claims for repurchases from the 1,098 claims DRR had processed. We assessed the Asset Claims staff decision on the disposition of each claim in relationship to the *Asset Claims Administration Procedures Manual*, internal management controls, and documentary support in the claims file. In selecting the 12 claims, we reviewed an *Asset Claims Ad Hoc Query* report from the Warranties and Representations Accounts Processing System (WRAPS)[22] and considered each of the three sales pools, evidence of acceptance and/or denial, and the dollar amount of the claim, focusing mainly on claims over $100,000. We also ensured that our sample contained the three most common reasons Beal listed for submitting the claim: (1) loan-to-value ratio at origination; (2) missing documentation, such as unrecorded first lien on the property; and (3) failure to disclose high-cost loan or predatory lending violations. We performed limited testing because we found no problems with the 12 claims we tested and because under the tolling agreement agreed to by Beal and the FDIC, Beal had ceased to submit further claims.

To achieve the audit objective, we used computer-processed data from DRR's WRAPS information system as well as sales information provided to us by responsible corporate officials. This information includes loan sale and subsequent repurchase claim activity. We also received testimonial information concerning the time spent by Asset Claims and Legal Division professionals for the performance of their duties regarding the Beal repurchase effort and the law suit. We used this information to place issues in the report in their proper context and to demonstrate their monetary impact. We tested the validity and reliability of the underlying information by comparing it to LSAs and other supporting documentation.

To gain an understanding of internal controls, our audit methodology included a review of the following:

- DRR's ADM,
- DRR's *Bridge Bank Manual,*
- DRR's *Asset Claims Administration Procedures Manual,*
- FDIC's Delegation of Authority Resolutions,
- case memoranda for the sales initiatives, and
- minutes of meetings held by the FDIC and New Superior's Board of Directors.

Our methodology also included interviews with and/or obtaining documents from the:

- DRR's Franchise and Asset Marketing Branch in Washington, D.C., and DRR's Field Operations Branch in Dallas, Texas;
- DRR Asset Claims Unit in Washington, D.C.;
- Legal Division in Dallas, Texas, and Washington, D.C.; and
- Division of Administration contracting officials in Dallas, Texas.

[22] WRAPS is the management information system used by DRR's Asset Claims Unit to monitor and enact the asset claims program and its functions.

We performed our work at the FDIC's offices in Washington, D.C., and Dallas, Texas, from December 2003 through March 2004. We conducted the audit in accordance with generally accepted government auditing standards.

Prior Audit Coverage

The FDIC's OIG has issued three previous reports that relate to our audit of the repurchases of New Superior loan assets to Beal Bank. The following summarizes our findings in the previous reports.

- OIG Audit Report No. 02-005, *Issues Related to the Failure of Superior Bank, FSB, Hinsdale, Illinois*, dated February 6, 2002. We found that the failure of Superior Bank was directly attributable to the failure of bank management and the board of directors to institute sound risk management principles and to adequately oversee the bank's operations. Specifically, bank officials permitted the institution to concentrate its business too heavily in high-risk assets (residual assets resulting from Superior's securitizing of loans) without maintaining adequate financial resources to withstand potential losses.

- OIG Audit Report No 02-002, *Least Cost Decision of Superior Bank and Liquidation of Remaining Receivership Assets*, dated February 8, 2002. We reported that the FDIC's Board of Directors made its decision to place Superior in conservatorship primarily based on DRR's recommendation and the information presented in the DRR's Failing Bank Case. The Failing Bank Case for Superior Bank presented two resolution alternatives to the Board, namely, conservatorship and immediate receivership and sale, which were compared to the cost of liquidating Superior. We also reported that the projected losses to the deposit insurance fund for these options were not supported by complete financial analyses.

- OIG Audit Report No 02-024, *Marketing and Resolution of Superior Federal, FSB (New Superior)*, dated July 24, 2002. We reported that DRR effectively marketed Superior's deposit liabilities and assets to maximize the return to the conservatorship. We also noted cases in which documentation required by DRR's policies and procedures was missing from the securities sales files. We concluded that maintaining complete sales files provides assurance that the FDIC fulfilled its obligation to maximize the return, minimize the loss, ensure adequate competition and fair treatment of offerors, and prohibit discrimination in the solicitation and consideration of offerors as required by Section 123 of the Federal Deposit Insurance Corporation Improvement Act.

SUMMARY EXCERPTS OF PROVISIONS FOR EACH LOAN SALES AGREEMENT

The following summarizes the R&Ws provisions and the other provisions for loan repurchases for the (1) FDIC's Standard LSA, (2) Old Superior's Scratch and Dent LSA, (3) New Superior's Scratch and Dent I LSA, (4) New Superior's Scratch and Dent II LSA, and (5) New Superior's Final Sale LSA.

FDIC Standard LSA

- *Representations and Warranties*:

  As is and with all faults

- *Provisions for Repurchase*:

  Borrower discharged in no asset bankruptcy
  Court decree of no enforceable obligation
  Failed bank or seller delivered a release of liability
  Title defect exists in connection with the property
  Seller is not owner of the loan
  Significant and undisclosed environmental contamination of collateral
  180 days after closing notice requirement (360 for contract for deed)

Old Superior's Scratch and Dent LSA

- *Representations and Warranties (27 items)*:

  Information set forth on Mortgage Loan Schedule is correct
  No delinquent real estate taxes or assessments affecting mortgaged property
  Terms of the note have not been impaired, waived, or modified
  Servicing and collection practices have been proper and customary
  Mortgage note is a legally binding obligation
  Proceeds of the loan have been fully disbursed and no requirement for advances
  Mortgage is a valid first lien or a disclosed second lien
  Loans with primary mortgage insurance are covered in excess of 75% of appraised value
  No fraud, misrepresentation, or negligence on the part of the loan originator
  Loans are covered by a lender's title insurance policy
  Trustee has been properly designated if mortgage constitutes a deed of trust
  No improvement on the mortgaged property has violated zoning laws
  Assignment of mortgage is in a recordable form
  None of the loans are subject to an undisclosed buy down agreement
  Mortgaged property has not been damaged by fire, vandalism, flood, or other casualty
  All terms related to interest rate adjustments are enforceable
  Mortgaged property complies with applicable environmental laws
  Servicing agreement provides for termination of servicing rights without fee

Mortgage loan complies with applicable consumer protection laws
Parties in the mortgage are in compliance with licensing requirements
Parties have the legal capacity to enter into the mortgage loan
No condemnation proceeding of the mortgaged property is pending
Mortgage note contains customary and enforceable provisions
No undisclosed action, suit, or proceeding is pending or likely to be asserted
No undisclosed default, breach, or acceleration event exists under the mortgage
No mechanics' lien affects the mortgage property
Mortgage file is complete and contains correct copies of each document

- *Provisions for Repurchase*:

Any breach of the representations and warranties that adversely affects value
60 days after receipt of notice the breach can be cured or loan repurchased

New Superior's Scratch and Dent I LSA (identical to Old Superior's representations and warranties)

- *Representations and Warranties (27 items)*:

Information set forth on Mortgage Loan Schedule is correct
No delinquent real estate taxes or assessments affecting mortgaged property
Terms of the note have not been impaired, waived, or modified
Servicing and collection practices have been proper and customary
Mortgage note is a legally binding obligation
Proceeds of the loan have been fully disbursed and no requirement for advances
Mortgage is a valid first lien or a disclosed second lien
Loans with primary mortgage insurance are covered in excess of 75% of appraised value
No fraud, misrepresentation, or negligence on the part of the loan originator
Loans are covered by a lender's title insurance policy
Trustee has been properly designated if mortgage constitutes a deed of trust
No improvement on the mortgaged property has violated zoning laws
Assignment of mortgage is in a recordable form
None of the loans are subject to an undisclosed buy down agreement
Mortgaged property has not been damaged by fire, vandalism, flood, or other casualty
All terms related to interest rate adjustments are enforceable
Mortgaged property complies with applicable environmental laws
Servicing agreement provides for termination of servicing rights without fee
Mortgage loan complies with applicable consumer protection laws
Parties in the mortgage are in compliance with licensing requirements
Parties have the legal capacity to enter into the mortgage loan
No condemnation proceeding of the mortgaged property is pending
Mortgage note contains customary and enforceable provisions
No undisclosed action, suit, or proceeding is pending or likely to be asserted
No undisclosed default, breach, or acceleration event exists under the mortgage

No mechanics' lien affects the mortgage property
Mortgage file is complete and contains correct copies of each document

- *Provisions for Repurchase*:

  Any breach of the representations and warranties that adversely affects value
  60 days after receipt of notice that the breach can be cured or loan can be repurchased

New Superior's Scratch and Dent II LSA (identical to Old Superior provisions except for deletion of the delinquent real estate tax and primary mortgage insurance in excess of 75 percent of appraised value representations and warranties)

- *Representations and Warranties (25 items)*:

  Information set forth on Mortgage Loan Schedule is correct
  Terms of the note have not been impaired, waived, or modified
  Servicing and collection practices have been proper and customary
  Mortgage note is a legally binding obligation
  Proceeds of the loan have been fully disbursed, and there is no requirement for advances
  Mortgage is a valid first lien or a disclosed second lien
  No fraud, misrepresentation, or negligence on the part of the loan originator
  Loans are covered by a lender's title insurance policy
  Trustee has been properly designated if mortgage constitutes a deed of trust
  No improvement on the mortgaged property has violated zoning laws
  Assignment of mortgage is in a recordable form
  None of the loans are subject to an undisclosed buy down agreement
  Mortgaged property has not been damaged by fire, vandalism, flood, or other casualty
  All terms related to interest rate adjustments are enforceable
  Mortgaged property complies with applicable environmental laws
  Servicing agreement provides for termination of servicing rights without fee
  Mortgage loan complies with applicable consumer protection laws
  Parties in the mortgage are in compliance with licensing requirements
  Parties have the legal capacity to enter into the mortgage loan
  No condemnation proceeding of the mortgaged property is pending
  Mortgage note contains customary and enforceable provisions
  No undisclosed action, suit, or proceeding is pending or likely to be asserted
  No undisclosed default, breach, or acceleration event exists under the mortgage
  No mechanics' lien affects the mortgage property
  Mortgage file is complete and contains correct copies of each document

- *Provisions for Repurchase*:

  Any breach of the representations and warranties that adversely affects value
  60 days after receipt of notice that the breach can be cured or loan can be repurchased

New Superior's Final Sale LSA Pools 1A and 1B (identical to Old Superior provisions except for deletion of the correct loan-to-value (LTV) information, delinquent real estate tax, primary mortgage insurance in excess of 75 percent of appraised value, and termination of servicing rights without fee representations and warranties)

- *Representations and Warranties (24 items)*:

  Information set forth on Mortgage Loan Schedule is correct (not including LTV)
  Terms of the note have not been impaired, waived, or modified
  Servicing and collection practices have been proper and customary
  Mortgage note is a legally binding obligation
  Proceeds of the loan have been fully disbursed and there is no requirement for advances
  Mortgage is a valid first lien or a disclosed second lien
  No fraud, misrepresentation, or negligence on the part of the loan originator
  Loans are covered by a lender's title insurance policy
  Trustee has been properly designated if mortgage constitutes a deed of trust
  No improvement on the mortgaged property has violated zoning laws
  Assignment of mortgage is in a recordable form
  None of the loans are subject to an undisclosed buy down agreement
  Mortgaged property has not been damaged by fire, vandalism, flood, or other casualty
  All terms related to interest rate adjustments are enforceable
  Mortgaged property complies with applicable environmental laws
  Mortgage loan complies with applicable consumer protection laws
  Parties in the mortgage are in compliance with licensing requirements
  Parties have the legal capacity to enter into the mortgage loan
  No condemnation proceeding of the mortgaged property is pending
  Mortgage note contains customary and enforceable provisions
  No undisclosed action, suit, or proceeding is pending or likely to be asserted
  No undisclosed default, breach, or acceleration event exists under the mortgage
  No mechanics' lien affects the mortgage property
  Mortgage file is complete and contains correct copies of each document

- *Provisions for Repurchase*:

  Any breach of the representations and warranties that adversely affects value
  60 days after receipt of notice that the breach can be cured or loan can be repurchased

New Superior's Final Sale LSA, Pools 2 and 3 (similar to the FDIC's Standard LSA except for addition of the HOEPA provision for repurchase and the longer 3-year notice requirement)

- *Representations and Warranties*:

  As is and with all faults

- *Provisions for Repurchase*:

  Borrower discharged in no asset bankruptcy
  Court decree of no enforceable obligation
  Seller delivered a release of liability
  Seller is not owner of the loan
  Mortgage loan classified as high-cost loan under HOEPA
  3-year notice requirement

CORPORATION COMMENTS

FDIC

Federal Deposit Insurance Corporation
1776 F. Street NW, Washington, D.C. 20429-9990

Division of Resolutions and Receiverships

DATE: September 7, 2004

MEMORANDUM TO: Stephen M. Beard
Deputy Assistant Inspector General for Audits

FROM: Mitchell L. Glassman, Director Mitchell L. Glassman
Division of Resolutions and Receiverships

SUBJECT: Draft Report Entitled *Repurchases of Superior Federal, FSB Loan Assets* (Assignment No. 2003-046)

This memorandum is in response to the subject draft report dated August 25, 2004. In summary, we disagree with the audit's findings and recommendations regarding the sale of loans from the Superior Federal, FSB, conservatorship (New Superior), and the development and utilization of related Representations and Warranties (R&Ws) and Loan Sale Agreements (LSAs). The draft report and its recommendations do not consider, particularly for a bridge bank or conservatorship, that the facts and circumstances of an institution should be a primary driver in making business decisions and establishing documentation requirements. We believe that a bridge bank's or conservatorship's existing policies, procedures, and practices should serve as the foundation for its operations and that those be modified as needed and as practicable to reflect its changed status.

Adequate Due Diligence

DRR disagrees with the finding that there was inadequate due diligence to offer the R&Ws. DRR used a multifaceted approach to due diligence based on the facts and circumstances of the Superior conservatorship. DRR staff conducted Asset Valuation Reviews (AVRs), the standard due diligence process for DRR's loan sales, for the Scratch and Dent (S&D) loan sales, sampling a statistically significant number of loans from each pool offered in the sales, resulting in a review of 327 loans out of 1749 loans offered in these sales. Although the draft report characterizes this sampling approach as "limited due diligence," each pool's sample was constructed with a 95% confidence level.

Additionally, because of the unique nature of New Superior being a conservatorship and its business model of originating and selling loans, DRR factored New Superior's loan origination and servicing operations as well as actual R&W put-back experience from Old Superior's prior sales and put-back experience from RTC sales that offered market-typical R&Ws into its decision to continue Superior's practice of offering market-typical R&Ws. New Superior had a

September 7, 2004

comprehensive subprime mortgage loan pipeline origination and sales operation based in Orangeburg, NY. Generally, loan brokers/direct lenders would submit loan applications underwritten for a New Superior loan program to one of its branches where New Superior employed a staff of approximately 270 New Superior underwriters. The underwriters in turn would ensure that an application was underwritten according to New Superior's guidelines, or that variances were justified based on compensating factors, before the application was accepted and funded. As an additional check on quality control and compliance for funded loans, New Superior employed 21 auditors in its Quality Control and Compliance Departments who, through a 200 question questionnaire, reviewed credit documentation, legal documents, and appraisals, and evaluated compliance with consumer regulations. DRR asset marketing staff also coordinated the sales with New Superior's servicing department, by identifying loans that were to be included in the sales, the R&Ws to be offered, and requesting that loans not meeting the R&Ws be identified so they could be offered in a sale with limited R&Ws. In its report, the OIG failed to recognize that as conservator, FDIC employed this staff, which effectively conducted on-going due diligence of the loan portfolio, both in the origination process and its servicing department, under the supervision of FDIC's appointed CEO, with oversight by DRR staff.

It also should be noted that neither the Treasury Department OIG Material Loss Review, the GAO Report, nor the FDIC OIG cited Superior's underwriting or servicing operations as a contributing cause of its failure.

Use of R&Ws Adequately Supported by Case and Other Documentation

The OIG report states that there was insufficient case documentation supporting the offering of the R&Ws in these sales. We disagree with this finding. The New Superior Board of Directors (the Board) approved the use of R&Ws at its August 16, 2001 Board meeting. A case, written by DRR-Asset Marketing Dallas staff, requesting the use of market-typical R&Ws (*Modifications to Current and Future Loan Sale Agreements – Company and Individual Loan Representations and Warranties*) was presented to the Board (Attachment 1). The case and its attachments included documentation associated with the types of R&Ws Superior offered prior to conservatorship, reviews by DRR and Legal Division staff, similarity of Superior's R&Ws to those RTC offered in its sales and their repurchase history, the added value of offering market-standard R&Ws, and current subprime market standards for typical R&Ws.

For example, Old Superior's R&Ws in its Merrill Lynch forward sale agreement included 15 R&Ws about the company and 77 R&Ws about the individual loans. The R&Ws recommended to the Board were to modify existing and future agreements to reflect New Superior's changed status. The Board and other attendees engaged in extensive discussions and deliberations about the risks and benefits offered by R&Ws, including Superior's repurchase history, as reflected in the minutes from that meeting (Attachment 2). Additional documentation in the form of e-mails, reports, and memoranda that were not included as case attachments, served as "work papers". The R&Ws for the S&D sales were modified to remove the R&Ws dealing with performance of the loans after origination. The final sales had 25 R&Ws about the loans and 7 company R&Ws. The IG report states on page 8: "We reviewed the well documented R&Ws development effort

September 7, 2004

for the Forward Sales LSAs, but had difficulty establishing a direct link to the S&D sales because the supporting documentation did not clearly tie together the two sales initiatives". DRR believes there was adequate linkage established in the minutes of the meeting and the New Superior Board resolution that approved the use of market standard R&Ws that stated: "...with respect to the Equity One, First Boston and Countrywide transactions [i.e., the Forward Sales] *and all future sales with similar reps and warranties*". DRR agrees that the audit trail would have been clearer if the individual sales cases that followed had referred to this blanket case approval, however; it was clear to the Board (as evidenced by Board minutes of subsequent meetings and staff e-mails) that this approval covered all future loan sales.

Also on page 8, the OIG Report attempts to question the applicability of the R&W case to all loan sales by stating: "...the S&D sales to Beal vastly differed from DRR's Forward Sales effort..." To justify its assertion, the Report then makes statements that are neither correct nor relevant to the issue of using market R&Ws in New Superior's loan sales. For example, the Dallas Asset Marketing staff that was directly overseeing the S&D I sale authored the R&W case approved by New Superior's Board - not the conservatorship staff directly conducting the Forward Sales. And, although 23% of the loans sold to Beal were from S&D sales which contained loans not sold through securitization or earlier forward sale agreements generally due to delinquency (see Attachment 3, excerpt from DRR's financial advisor's *Asset Valuation and Disposition Report*, dated September 6, 2001), the Report does not explain the relevance to the specific R&Ws provided in the S&D sales. The relevant facts are that the loans sold in all of New Superior's loan sales came from the same loan origination platform and were serviced by Superior, and the S&D sales did not provide R&Ws for performance, only for their origination documentation and servicing.

Beal Bank Claims Not Viewed in Context of Total New Superior Repurchase Claims

By only focusing on the Beal Bank (Beal) sales the OIG fails to put these three sales in the context of the total loan pipeline sale operation at the New Superior conservatorship. The report ignores the majority of loans New Superior sold and is solely focused on the sale of 5,315 loans to Beal. All other sales of subprime mortgages, which included 7,362 loans and provided similar R&Ws, were not included in the OIG review. From the other sales, only a total of 968 claims were filed, of which 405 were approved (Attachment 4). This is an approved claim rate of 5.5%, which is in line with Superior's 5.0% put back history on sales prior to failure (Attachment 5). It should also be noted that, as stated earlier, DRR gave significant consideration to the historical repurchase data that Superior kept with respect to repurchase activity concerning different sale transactions. Specifically, in the (Old) Superior Bank, FSB/EMC Scratch and Dent Sale (BV $41.2MM – closed 6/26/01) only $211,256 in repurchases (.51%) was approved. The Superior/EMC sale agreement was used as the base document to formulate the LSA. It must be noted that EMC has submitted only 2 additional claims on this pool over the last three years. In addition, the 273 loans totaling $19.4 million that were sold in S&D I to Truman Capital have experienced a similar low put back rate. There are only 8 (2.9%) approved claims from this pool (Attachment 6).

September 7, 2004

Beal Bank Results Not Differentiated or Correlated to R&Ws

The OIG provides no evidence to support any cause and effect between the New Superior LSA and Beal's claims. The original case approving the use of R&Ws showed that Superior had experienced a 5% approved claim rate prior to failure, and the Beal experience is not out of line with this. There is no analysis of the type of claims submitted, the types approved or the type rejected. The report implies that additional due diligence would have changed the R&Ws offered or reduced the number of put backs. In Finding B of the report, the OIG indicates that the FDIC's decisions to accept or deny Beal claims were adequately supported. Of the 1,098 Beal claims processed, only 246 have been approved. Thus, it is apparent, and supported by the OIG's own finding, that Beal has submitted a substantial number of invalid claims. No amount of due diligence would predict or prevent this. Additionally, the OIG provided no analysis of either the cost or benefit of conducting additional due diligence. For instance, fraudulent loans would not be detected in a loan file review, and it would be extremely difficult to detect all the Home Owners Equity Protection Act (HOEPA) violations in a due diligence review (discussed later in this document).

A section of the sales case specifically addresses the R&Ws as follows: "...the reps and warrants offered in this sale are typical of those previously used by Superior Bank, FSB, in the sub-prime scratch and dent market and are contained in the mortgage loan purchase agreement attached as Exhibit A. The FDIC will provide a Corporate Guaranty of Superior Federal Bank FSB's R&Ws up to an amount equal to 10% of the principal balance of the pools sold as of the loan sale cut-off date for a period not to exceed three years from the sale closing date. The Agreement has been prepared by DFOB Legal and approved by FDIC DC Legal." The language in the R&W case and S&D sales cases, collectively, justify and substantiate that the R&Ws offered were very similar to those used by the former bank and the industry.

Home Owners Equity Protection Act (HOEPA)

The OIG failed to distinguish between the HOEPA representations and the other representations. For public policy purposes, DRR did not want to sell loans with HOEPA violations to any buyer and attempted to discover these loans during the due diligence and packaging phase. We knew that it would be expensive, difficult and time consuming to attempt to find all of these loans, so the HOEPA provision was included in all the sales agreements to allow FDIC to repurchase these loans. This was not done to enhance the value of the pools, but to allow FDIC to correct these violations rather than leave loans with HOEPA violations in the private sector. The vast majority of the approved Beal claims (187 out of 246 loans) were due to HOEPA violations. These violations generally involved under-disclosure of between $100 and $400 in loan fees. The rules for determining HOEPA loans are not always clear. In fact, a contractor hired by DRR to review the HOEPA loans that were repurchased found that 65 of the 159 loans they reviewed were not HOEPA violations (Attachment 7). In reality only a very small percentage (1.5%) of the Beal loans have been repurchased for non-HOEPA reasons.

September 7, 2004

The report characterizes these loans as "predatory loans" and "violating predatory lending practices" without any supporting documentation. Although these loans potentially violated the HOEPA disclosure rules and, when combined with other facts, may be indicative of predatory lending practices, there has never been a finding that Superior engaged in predatory lending. Neither OTS nor DSC ever had an examination finding that Superior's lending practices were predatory.

Recommendations

DRR staff disagrees with Finding A of the Report and its two recommendations. However, recognizing the importance of documenting business decisions, by September 30, 2004, DRR will amend Section 2A of the Bridge Bank Manual to read: "The Bridge Bank Board of Directors should adopt policies for documenting business decisions and will distribute the policy to Bridge Bank management and to FDIC personnel working with the Bridge Bank."

Attachments

cc: James Wigand
Stan Ivie
Herb Held
James LaPierre
George Alexander
Howard Cope
James Hepburn
James H. Angel, Jr.
Susan Koepp

APPENDIX IV

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents management's response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Dispositioned:[b] Yes or No	Open or Closed[c]
1	Management does not concur with the recommendation.	None Provided	N/A	No	No	Open
2	Management does not concur with the recommendation.	None Provided	N/A	No	No	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

[c] Once the OIG dispositions the recommendation, it can then be closed.