The Lessons of Superior

By John Reich

It was like déjà vu all over again.

Two weeks ago, the Federal Deposit Insurance Corporation entered Superior Bank, FSB and took over as conservator. The failure of this Chicago-area thrift will likely be one of the costliest in recent memory. That's bad enough, but Superior wasn't an anomaly.

Since 1998, the FDIC has lost more than a billion dollars to failures that share a disturbingly similar profile with Superior: a volatile mix of poor management and internal controls, faulty accounting opinions, and portfolios heavy on subprime lending. In some cases - Superior included - the banks also held risky assets resulting from securitizations.

Trapped in this vortex, these apparently healthy banks failed with alarming suddenness. Now, following Superior, we have entered another round of appropriate questions about how the failure happened, who is responsible, and where we should go from here.

But the lessons of Superior will not be new ones. In fact, the FDIC has been making the case for years that several volatile factors were figuring more prominently in troubled institutions and were increasing the risk to the deposit insurance funds. We have outlined several policy proposals we believe would help prevent this unfortunate scenario from repeating itself.

But the lengthy rulemaking process, a fragmented regulatory structure, and industry inattention has prevented a quick and comprehensive approach to addressing these concerns.

Superior's failure may finally create the motivation necessary for us to get the job done, particularly in three areas:

Poor management and subprime lending. When mixed, they doomed Superior. Clearly, there is nothing inherently harmful in subprime lending and most subprime lenders are well capitalized and well managed. But, without question, it is a risky activity that bears close scrutiny.

About one-and-a-half percent of insured institutions have significant subprime portfolios. Yet, these lenders represent about 20 percent of the banks on the FDIC's 'problem bank' list. We regulators must make sure these lenders hold enough capital to cover the risks they face.

Interestingly enough, non-bank subprime lenders are far better capitalized than their FDIC-insured cousins. In 1998, the common equity capital ratio for non-bank subprime lenders was 22.5 percent, as compared to 10.3 percent in banks conducting those activities. This disparity occurs because market pressures force the non-bank lenders to hold more reserves in order to attract investment. Is there any reason banking regulators cannot do the same?

The potential for regulatory arbitrage here concerns me. I want to make sure the FDIC's product remains oriented toward providing deposit insurance and depositor confidence. It should not be a shortcut to avoiding market discipline on risky activities.

Residuals and accounting opinions. As with management and subprime lending, volatile assets and accounting valuations are linked. Without question they figured prominently in the demise of Superior and other recent costly failures.

A residual is that portion of the loan risk and revenue stream retained in the bank after the remainder of the loan has been securitized and sold. These assets are highly volatile and it is difficult to precisely determine their value. Accounting for them rests on assumptions which are sometimes faulty and always subject to change.

Often, these assumptions are validated by reputable accounting firms, giving the numbers a heft they may not deserve. If the assumptions change and the value can plummets, an institution's equity capital can be severely impaired.

This is precisely what happened in the failures of Superior and others and we have already started working on this problem. Last year we released for comment a proposal requiring dollar-for-dollar capital against residuals and limiting institutions' residuals exposure to 25 percent of tier-one capital.

We are still reviewing comments working on the language. We should iron out the details and move forward with this rule. It would go a long way toward solving the residuals problem and protecting the FDIC from sudden, costly failures.

I am also concerned about situations where an accounting change-of-heart can - in one fell swoop - render an apparently healthy bank insolvent. We should do more to scrutinize assumptions and require good accounting.

Interagency cooperation and FDIC access. The FDIC needs full access to all banks and thrifts. We should be able - as needed - to assess financial condition and the degree of risk to the deposit insurance funds, as well as make preparations for handling a troubled institution if it should fail. Two heads are better than one in situations where a bank's condition is deteriorating and the FDIC's insurance funds are on the line.

This reform begins at home. The FDIC Board's own complicated procedures inhibit our access when another regulator denies our participation. We ought to fix this and it will be one of my priorities.

These are important lessons we should learn from the failure of Superior Bank. The unfortunate fact is we should have learned these lessons last time. Maybe this latest costly failure will give us the will to avoid another one of these episodes of déjà vu all over again.

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