

ASSESSMENT OF DOS'S SUPERVISION OF BESTBANK

We concluded that the FDIC Division of Supervision's supervisory oversight could have been more effective in controlling BestBank's undisciplined growth, concentration in unsecured subprime lending, and poor underwriting practices, which represented a significant risk to the BIF.

DOS's supervisory oversight was severely hampered by the examiners' restricted access to the records supporting Century's financial statements even though Century (and its affiliated entities) completely managed and monitored the BestBank/Century credit card programs.¹ DOS's supervisory oversight also was hindered when bank management impeded the examiners' access to bank employees and records.

While DOS conducted timely examinations and appropriately applied Prompt Corrective Action provisions, we concluded that DOS missed opportunities to take more timely and effective supervisory actions at critical junctures in BestBank's history. Our recommendations in this section of the report address these issues, as well as methods to improve DOS's communication and coordination within the Corporation and with State banking agencies.

FDIC's Restricted Access to Century, BestBank's Third-Party Servicer, Impeded Examinations

DOS examiners were severely hampered by restricted access to records supporting Century's financial statements even though Century (and its affiliated entities) completely managed and monitored the BestBank/Century credit card programs. While Century contractually agreed to indemnify the bank for losses associated with the related credit card programs, Century also had control over identifying and reporting past due accounts to the bank. This control was significant considering that the BestBank/Century subprime credit card receivables represented 71 percent of the bank's total assets as of May 29, 1998. These receivables comprised the majority of the bank's total credit card receivables, which had grown from \$42 million in December 1996 to approximately \$236.8 million in July 1998.

Although Century exercised substantial control over the BestBank/Century credit card programs, DOS Dallas believed, after consulting counsel, that Century was not an affiliate of the bank and, therefore, the FDIC lacked statutory authority to examine Century. When the FDIC finally gained access to Century's data processor in June 1998, the examiners determined that Century had not accurately identified and reported the past due credit card accounts. In addition, Century did not have the financial capability to indemnify the bank for losses associated with the related credit card programs. We believe FDIC examiners need to have prompt, unrestricted access to organizations that

¹ While FDIC and State examiners reviewed credit files at Century's Bank Card Center in Thornton, Colorado, during the October 1996 and 1997 examinations and spoke with one of Century's principals and a CPA who worked for Century, the examiners did not obtain the access they needed to evaluate the records supporting Century's financial statements.

exercise significant control over an insured institution's loan portfolio, particularly when the institution is relying on the servicer to indemnify the bank for any losses in the loan portfolio and to provide information to the bank regarding the status of the portfolio. Without this access, the examiners cannot determine the insured institution's true financial condition and potential risk to the BIF.

As we discussed earlier in this report, BestBank and Century signed a Marketing, Processing and Consulting Agreement in February 1994 whereby Century would indemnify the bank against losses on related credit card accounts delinquent more than 120 days. The delinquency period was subsequently reduced to 60 days. The agreement also included a statement that "Century agrees to submit to any examination which may be required by any regulatory agency with audit and examination authority over Bank, to the fullest extent of such regulatory authority." Although this clause appeared to provide the banking regulators access to records supporting the financial statements for Century, DOS Dallas believed, after consulting counsel, that Century was not an affiliate of the bank and, therefore, the FDIC did not have access to Century. Federal Reserve Act section 23A, which defines an "affiliate," does not specifically address entities whose business relationship with the bank has the ability to significantly affect the safety and soundness of the insured financial institution. In addition, the Federal Reserve Board's interpretations under section 23A do not specifically address a relationship like that of BestBank and Century.

In 1996, DOS Dallas believed, after consulting counsel, that the FDIC did not have access to records supporting Century's financial statements through the Bank Service Corporation Act because Century's stock was not owned by one or more insured banks. While the Dallas Regional Counsel considered other remedies available to the FDIC, none provided the immediate, unrestricted access the examiners required with regard to Century.

The FDIC also missed subsequent opportunities to gain access to records supporting the financial statements for Century. In January 1997 and in March 1998, the FDIC received allegations of wrongdoing related to the BestBank/Century credit card programs. According to the Dallas Regional Counsel, the FDIC may have had the opportunity to gain access to records supporting the financial statements for Century by initiating a section 10(c) investigation based on the January 1997 allegations.

During our audit, the Dallas Regional Counsel told us that she believed that the FDIC may have gained this access to Century in October 1997. At that time, the examiners became aware of a January 1997 revised marketing agreement that the Dallas Regional Counsel considered to be broader language related to the examination of Century. Through this agreement, the FDIC eventually gained access to records supporting the financial statements for Century in June 1998. In each of the preceding opportunities, we found no evidence that DOS notified the Dallas Regional Counsel. According to the DOS Dallas Regional Director, the Dallas Regional Counsel had previously determined that the FDIC did not have access to

Century. Apparently the allegations and revised marketing agreement were not brought to the Dallas Regional Director's attention until early 1998.

The October 1996 and 1997 examination reports reflect the examiners' compelling need to gain prompt, unrestricted access to records supporting Century's financial statements. According to the October 1996 examination report, the bank's assets grew by \$11.7 million in approximately 4 1/2 months, from \$42.1 million at the end of June 1996 to \$53.8 million by the middle of November 1996. Credit card receivables represented 79 percent of the bank's loan portfolio at September 30, 1996. While the bank relied entirely on Century to indemnify losses in the subprime credit card portfolio, bank management had only limited financial information on Century. The examiners questioned the reliability of this information and would have liked to review Century's support for several changes in the financial statements. Specifically, the examiners identified a \$1.6 million reduction in Century's gross revenue from November to December 1995 that neither Century nor BestBank could reasonably explain. In addition, the examiners questioned a \$2.7 million and a \$1.4 million increase in two of Century's expense accounts that seemed to warrant further investigation.

According to the October 1997 joint examination report, the bank's assets grew 164 percent in one year, from \$42 million at the end of June 1996 to \$111 million at the end of June 1997. Century-related credit card receivables represented 92 percent of the bank's loans. The examiners observed that "without Century's indemnification, virtually the entire credit card portfolio of subprime borrowers would be classified, the bank's capital position would immediately deteriorate, losses would quickly escalate as the accounts on the books past six months would be largely uncollectible, and income would decline without a constant influx of new receivables." The examiners noted that while the evaluation of Century had become the crux of the examination, the examiners were "largely handcuffed by the apparent lack of demonstrable affiliation between the two entities."

We believe DOS and the Dallas Regional Counsel should have worked more diligently to find alternative ways to gain access to records supporting Century's financial statements. The bank's credit card programs grew exponentially from \$42 million in December 1996 to approximately \$236.8 million in July 1998 and made it all the more important for examiners to confirm Century's ability to continue indemnifying the bank's losses. The Legal Division has indicated to us that it is evaluating the full scope of examiners' authority and procedures that could be used with a recalcitrant institution.