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TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

LINCOLN SAVINGS AND LOAN ASSOCIATION OF CALIFORNIA

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

10:00 A.M.
October 17, 1989
Room 2128, Rayburn House Office Building

Good morning, Mr. Chairman and members of the Committee. I am pleased to be here today to provide information relating to the Lincoln Savings and Loan Association of California.

The FDIC is vitally interested in Lincoln Savings. As the insurer of thrifts, and as the manager of the Resolution Trust Corporation ("RTC"), we are especially anxious to see that losses relating to Lincoln are reduced to a minimum. We have recently filed suit to recover monies we believe are due Lincoln's estate and the RTC. (A copy of the complaint is being provided as an Attachment.)

You have requested us to address four specific concerns. These are: (1) the financial condition of the institution at the time FDIC was appointed conservator; (2) FDIC's assessment of the prior management of the institution; (3) practices by prior management that contributed to the institution's failure; and (4) FDIC's analysis of the supervisory history of Lincoln Savings with an emphasis on how future supervisory efforts can be improved. Before addressing these specific areas, we would like to provide some background with respect to the FDIC's involvement in Lincoln.

Lincoln Savings was placed in conservatorship on April 14, 1989. At that time a team headed by the FDIC was placed in Lincoln as part of the overall plan to conserve assets within the thrift industry and to prepare insolvent thrifts for eventual sale or dissolution. Prior to that date the Federal Home Loan Bank Board was responsible for the regulation and oversight of Lincoln. Lincoln was placed in conservatorship after a finding by the Bank Board that it was operating in an unsafe and unsound manner. Subsequently, Lincoln was found to be insolvent.

Upon entering Lincoln, our goal--as it was in each conservatorship--was to:

- o Establish control and oversight of the institution
- o Promote confidence and maintain customer services
- o Evaluate the institution's condition and identify and account for losses
- o Recommend viable alternatives for cost controls and for the least cost resolution of the case

1. THE FINANCIAL CONDITION OF THE INSTITUTION AT THE TIME FDIC WAS APPOINTED CONSERVATOR

In summary, at the time we became conservator, we found Lincoln to be insolvent due to substantial reserves for losses that had to be recorded. Lincoln was insolvent on a liquidity basis as well because it was unable to meet its obligations as they came due. In accordance with normal practice, upon being appointed conservator, we reviewed Lincoln's financial statements to adjust them as required and to provide appropriate valuation reserves on a going concern basis. We also made a preliminary estimate of the range of loss on a liquidation basis (i.e. estimated loss to the RTC).

Lincoln's major problems included (1) a portfolio of non-earning loans; (2) a real estate investment portfolio, consisting primarily of investments in raw land; (3) investments in high-yield and privately-placed bonds and equities with significant credit quality problems and interest-rate risk; and (4) a $1.5 billion mismatch between interest-bearing and interest-earning assets, resulting in a severe liquidity problem.

When Lincoln was placed into conservatorship, the books for the year ending December 31, 1988 had not been closed pending completion of the independent audit by Touche Ross & Company, Certified Public Accountants. Regulatory financial statements,

as of February 28, 1989, had been submitted in late March to the State of California Department of Savings and Loan and the Federal Home Loan Bank Board. The last internal Statement of Condition for Lincoln Savings and Loan Association before the conservatorship was as of February 28, 1989.

The attached Table shows the adjustments we made for valuation reserves. Column D is a balance sheet on a consolidated basis prepared by prior management as of February 28, 1989. Column E adjusts for appropriate reserves, losses and income reversals. These adjustments were based upon estimates of value of Lincoln's assets made by the FDIC using all information available at that time. As part of this process, the loan loss reserve had to be increased by $289 million. The reserves against carrying values of real estate assets were increased by $432 million. Based upon these, and other adjustments reflected in the Table, Lincoln was insolvent by approximately $800 million at the time we were appointed conservator. As more information becomes available -- such as new appraisals -- reserves and other adjustments will be updated accordingly.

Lincoln's consolidated loan portfolio on April 14th consisted of only about $70 million in traditional single family mortgage loans and consumer loans, $370 million in secured commercial loans and $1 billion in acquisition, development and

construction ("ADC") loans. Lincoln also was committed to an additional $560 million in ADC loan disbursements. Approximately $250 million (15 percent) of Lincoln's loan portfolio was composed of loans made to purchasers of real estate from Lincoln and Lincoln subsidiaries.

The April 14 loan records reflected $60 million in non-accrual loans (i.e. loans on which interest income was not recognized until actual receipt by Lincoln). A review of all loans made it clear there were a number of additional loans that should be carried on a non-accrual basis. An additional $250 million in loans was therefore changed to non-accrual status.

Investments in real estate approximated $1.0 billion. This level of investment was the result of an aggressive internal land acquisition and development program. Many of these investments were large, as demonstrated by six projects, three with an investment of over $50 million each, and three in excess of $100 million each. The strategy was to acquire large parcels of raw, vacant land to be zoned and subsequently developed in master-planned communities providing a variety of land uses.

As of April 14, Lincoln's real estate investments in Arizona, Colorado, and Texas were approximately $700 million, $100 million, and $150 million, respectively. The investments

in Arizona were made during the period from 1985 to 1987 when the real estate market was strong. Substantially all the investments in Colorado and Texas were acquired during late 1984 and 1985, the peak of those real estate markets. The emphasis with each project was upon development activities. Few formal business plans addressing the ultimate disposition of the property were in place. As the level of investment in real estate grew, the lack of marketing plans, coupled with a deteriorating real estate market, made it difficult to generate sales sufficient to cover the carrying costs of these assets. Despite these facts, only minimal reserves against carrying values of assets existed. There were few current appraisals and market studies.

On April 14, 1989, Lincoln's investment portfolio included a myriad of securities, including high yield bonds with a cost of $646 million, and equity investments with a cost of $429 million. Approximately $500 million of these investments were in illiquid private placement securities. These securities possess a higher probability of default than rated bonds and sometimes are difficult to sell.

Lincoln's portfolio also included mortgage-backed and U. S. government securities with a book value of $1.85 billion. While these securities were liquid, $1.76 billion was pledged as collateral against various borrowings and other transactions.

Approximately $830 million of these securities were pledged against borrowings in which the declaration of bankruptcy by Lincoln's subsidiaries constituted default. As a result, this collateral was liquidated by the various brokerage houses, preventing an orderly liquidation of these assets.

Lincoln subsidiaries contain interests in operating entities; American Founders Life Insurance Company, Young Smith and Peacock brokerage firm, the Phoenician Resort and Crescent Hotel. Evaluation of these entities is being done using both internal records, outside experts, actuarial firms, and investment bankers. This process has been hampered for some of the entities by the holding company, American Continental Corporation ("ACC"), withholding subsidiary records in their possession on April 14. On September 29, we obtained a court order giving us access to the records of the subsidiaries and we will be examining them once access is obtained.

Lincoln Savings and Loan was experiencing a severe liquidity crisis on the date of conservatorship. It was unable to meet its obligations as they became due because of deposit outflows, losses and a lack of liquid assets.

Further, in a well-laid plan designed to make it more difficult for the regulators to carry out their duties as

conservator, the parent holding company, ACC, had filed for bankruptcy for itself and 11 of Lincoln's subsidiaries the day before Lincoln was placed in conservatorship. The bankruptcy filings removed the subsidiaries as a source of funds and no contingency plans for funding existed. On April 17th, Lincoln Savings was the first of only two institutions in the nation to enter the newly established Joint Lending Program of the Federal Reserve, the Federal Home Loan Bank and the Federal Savings and Loan Insurance Corporation.

As we previously stated, in accordance with our normal practice, a review was conducted to estimate the loss that would be involved in a liquidation of Lincoln. This estimate differs from our accounting adjusted estimate in that it takes into account liquidation and litigation costs, holding and sales costs and other factors involved in liquidation. That estimate shows an anticipated loss in the range of $1.5 billion to $2.0 billion. The estimate will be adjusted with further review of information as it becomes available.

<u>2. AND 3. FDIC'S ASSESSMENT OF THE PRIOR MANAGEMENT OF LINCOLN AND PRACTICES OF PRIOR MANAGEMENT THAT CONTRIBUTED TO LINCOLN'S FAILURE</u>

Prior to the FDIC's appointment as conservator of Lincoln, much of Lincoln's top management occupied dual positions as

employees of both ACC and Lincoln. Their salaries were apportioned on a set percentage basis between ACC and Lincoln. Immediately prior to the date of the conservatorship, many of these dual status managers resigned their Lincoln positions and became full-time ACC employees. These resignations continued for several days after the conservatorship when Lincoln employees were interviewed by the FDIC and its agents. The FDIC sought to determine who performed what roles and whether any remaining Lincoln employees were culpable of wrongdoing or would cooperate in the FDIC's investigation.

Through the interview process, and by working with remaining employees, the FDIC found evidence of culpable behavior on the part of an inner circle of Lincoln's former management. Some of those individuals have been named as defendants in the RICO and fraud case filed by the RTC.

On September 15th, the RTC, acting as conservator for Lincoln, filed a lawsuit against Charles H. Keating, Jr. and other corporate officers and insiders charging that they devised a number of complex and interrelated schemes to divert assets of Lincoln to their personal benefit, ultimately contributing to Lincoln's insolvency. The money which the defendants siphoned out of Lincoln came primarily from depositors whose accounts are

insured by the federal government. The suit seeks actual damages of $1.1 billion -- and portions could be tripled under racketeering statutes.

The RTC's complaint alleges the former management of Lincoln contributed significantly to its insolvency by structuring sham transactions which enabled them to siphon cash out of Lincoln for their personal benefit. Lincoln relied upon high cost brokered deposits to sustain rapid growth. Investments focused largely on high-risk assets with uncertain earning power such as raw land or other speculative investments such as corporate equities and junk bonds. Certain of those investments were used by Lincoln's management to structure certain inside transactions which were reported as though they created large profits. However, when the transactions were properly analyzed, gains reported by Lincoln were illusory and had to be reversed.

We believe that linked transactions were instituted in which certain parties received benefits to enable Lincoln to report sham profits. As a result of their improper inflation of Lincoln's and ACC's books, the insiders of Lincoln's former management were able to fund excessive salaries and dividends from ACC and reap fraudulent profits on the sale of ACC stock.

Many of these major transactions appear to have been orchestrated directly by Mr. Keating and a few insiders,

completely avoiding the use of underwriting staffs employed by the association. Many major loans were made on a non-recourse basis and with inadequate security.

We believe that the schemes used by the defendants involved both intentional fraudulent misdeeds and negligent activity. Elaborate misrepresentations, including sophisticated accounting abuses, were used to deceive the public about the true nature of the business being funded by Lincoln's depositors. The deception employed numerous false statements constituting wire fraud, mail fraud, bank fraud and securities fraud. Because the defendants employed a pattern of such activity in furtherance of their fraudulent schemes, the RTC has sought additional relief under the anti-racketeering laws of Arizona and the United States. This which would entitle the RTC to treble damages as an additional remedy designed to deter future misconduct by others, and to provide a more adequate remedy for the overall losses which are anticipated.

The schemes which caused Lincoln's failure required the contributions of many individuals. Certain Lincoln directors and officers, while perhaps not themselves directly engaged in fraud, owed a duty of care to Lincoln which they breached by failing to look out for Lincoln's best interests and exercise independent judgement. Consequently, the complaint also seeks damages for the negligent conduct on the part of these individuals.

The RTC has not completed its investigation of Lincoln. We believe that substantial additional investigation is warranted and may result in the filing of additional civil actions or allegations, including fraud actions. Some of the areas of additional investigation and potential causes of action which we believe warrant further review relating to Lincoln include:

1. Liability of accountants.

2. Liability of appraisers in appraising the real estate held, sold and purchased by Lincoln, its direct and indirect subsidiaries and holding companies.

3. Liability of attorneys in their counseling of and advice to ACC and Lincoln.

4. Liability of investment brokers and securities brokers.

5. Liability of borrowers, including possible straw borrowers, and kick-backs or side deals which those borrowers may have received.

6. Additional fraudulent or sham real estate transactions not included in the RICO Complaint.

7. Transactions relating to investments in and sales of securities and junk bonds.

8. The fraudulent sale, transfer or diversion of corporate assets or opportunities of Lincoln.

9. Additional transactions relating to the diversion of Lincoln's assets for the personal benefit of insiders and their associates as well as for use in making political contributions.

4a. FDIC'S ANALYSIS OF THE SUPERVISORY HISTORY OF LINCOLN SAVINGS

The FDIC did not attempt to evaluate past supervisory activities except to review reports which might be useful in our role as conservator. However, certain information can be gained from two examinations of Lincoln prior to conservatorship.

The earlier Report of Examination, dated March 12, 1986, completed jointly by the San Francisco Federal Home Loan Bank and the California Department of Savings and Loan found the following:

(1) $1.2 billion in direct investments violate the limitation on direct investments by $599,900,000.

(2) Serious deficiencies in policies and procedures for investment in corporate debt and equity securities, including lack of diversification, poor underwriting and absence of written underwriting standards, evidence of high risk and disregard of prudent investment.

(3) Numerous deficiencies in real estate investment underwriting standards such as appraisals, lack of feasibility studies and cash-flow projections, and high levels of concentrations.

(4) Numerous deficiencies in real estate loan funding, including heavy concentrations in raw land in Arizona, heavy concentrations in loans to one borrower, real estate loans granted without proper underwriting standards and numerous documentation deficiencies.

(5) Non-compliance with generally accepted appraisal standards.

(6) Substantial and well-defined weaknesses resulting in substandard loan classifications that total $47,100,000.

(7) Eight loans to one group totalling $79,000,000 reclassified from loans to joint ventures and the reversal of $2.8 million in recognized income.

(8) Failure to follow the Association's Community Reinvestment Act plan.

(9) Reversal of improperly capitalized interest and improperly capitalized expenses.

(10) Inadequate and non-existent records.

(11) Improper and speculative trading in options and forward commitments.

(12) Engaging in real property transactions with affiliate persons without receiving approval of the Principal Supervisory Agent.

While our mission did not include evaluating Lincoln's supervisory history, in order to respond to the question addressed to us by the Committee, I asked our professional examination staff to review the 1986 Report of Examination of Lincoln and to indicate how we might have reacted to the findings if it had been an institution under our supervision. They told me that the March 12, 1986 Report of Examination depicted an institution that warranted immediate enforcement action. Ownership of the association had changed about one year before and this Report documents that the institution had been transformed from a traditional association to a high-growth,

risky operation. My staff indicated that had we made such findings in one of our own institutions, we would have sought an immediate cease-and-desist order to stop the hazardous operations.

A new examination was undertaken by the Federal Home Loan Bank Board and reported on July 11, 1988. This examination revealed a large increase in classified assets when compared with classifications from the previous March 12, 1986 examination as shown by the following:

Examination Date	3-12-86	7-11-88
Substandard	39,600,000	706,501,099
Doubtful	-0-	34,365,375
Loss	7,500,000	59,635,377
Total	47,100,000	800,501,851

The Report of Examination dated July 11, 1988 stated that:

"While the institution met its regulatory capital requirement at the examination date, the specific losses identified coupled with the requirement to reverse certain transactions render the institutions ability to meet its future net worth requirement questionable. In any event it is the recommendation of this examination that an individual minimum net worth requirement be established for Lincoln. This

recommendation is based upon the level of problem assets, the volume of activity in assets possessing a higher degree of inherent risk than that of the more traditional financing of single-family dwellings and concentrations within these categories." (emphasis added)

The Report also stated: "The level of problem assets is significant at over 12 percent of total assets and four and one-half times capital. Further exacerbating the situation and risk to capital are the concentrations as well as the numerous investments that are illiquid and where the future performance of the assets is not within the control of management."

Based on the opinion of our professional supervisory staff, immediate supervisory action was warranted.

Our review upon becoming conservator less than one year later found Lincoln insolvent by approximately $800 million. Thus, either the 1988 Report did not reveal the true condition of Lincoln or large losses were taken during the intervening period as a result of the manner in which the thrift had been operating.

<u>4b. FUTURE SUPERVISORY EFFORTS</u>

The FDIC knows of no fool-proof solutions for preventing another thrift crisis or for preventing a recurrence of the

Lincoln Savings and Loan losses. What we can offer, however, are three fundamental principles of sound supervision that have served well over our 55-year history.

First, and this should come as no surprise, the FDIC believes the industry must be well capitalized. Capital is the industry's natural shock absorber. Well-capitalized institutions are better able to absorb losses, adjust to changing environments and take advantage of opportunities as they arise. Adequate capital levels also instill confidence in the public, permit healthy growth, and cushion the government from insurance losses. We believe owners of institutions who stand to gain from the success of an institution should have enough of their own capital at risk so that they stand to feel the loss if the institution fails. Clearly, the recent thrift crisis has shown that an undercapitalized industry is a destabilized industry. There is no better way to instill stability than to require owners to maintain reasonable capital in the institution. Nothing in recent history indicates that capital levels in thrifts, or banks, are too high under present standards.

Second, financial institutions must be required to adhere to proper accounting standards which reveal true financial condition. The practice of "papering over" losses or inflating

profits through accounting changes leads inevitably to costly reality at a future time.

Further, misleading accounting allows institutions with no real capital to operate on accounting-created illusory capital -- thus in effect eliminating capital standards and allowing unlimited growth. The use of accounting gimmicks in the early 1980s proved a very expensive lesson indeed for the American taxpayers.

Third, a supervisory staff and program must be in place that is tough, fair, responsive, industry independent and free of political pressures. The importance of the regulators' independence cannot be overstated.

Effective supervision protects the public. It also protects financial institutions that are coinsurers in the fund and are operating in a safe-and-sound manner. Such supervision need not be adversarial, but it must be "uninfluencable."

FIRREA has reduced the likelihood of the recurrence of cases similar to Lincoln. It provides for improved capital standards, tougher operating standards and stiffer penalties for those managers who would violate their positions of trust. The new law provides for stronger regulatory oversight of the industry

with an independent Office of Thrift Supervision as the primary Federal regulator and the FDIC as the backup Federal supervisor.

While much has been done to try to avoid the problems of the past by recent legislation, as always the most important factor to carry out the insurer's mandate is the existence of a professionally trained, competent and independent supervisory staff. That staff must be authorized to carry out its mandate of supervision of financial institutions without fear of outside influence. If Lincoln teaches us anything, it tells us that this group of government employees must be free to take action necessary to maintain safety and soundness. They are the essential thin blue line protecting the financial system and the taxpayer from billion dollar insurance losses.