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The State's Regulation of Financial Institutions

Senate Advisory Commission on Cost Control in State Government

CALIFORNIA STATE SENATE

ADVISORY COMMISSION ON COST CONTROL
IN STATE GOVERNMENT
MILTON G. GORDON, CHAIRMAN

Report on

THE STATE'S REGULATION OF FINANCIAL INSTITUTIONS

Submitted to the Senate Rules Committee
Pursuant to S.R. 40 (1984)
February, 1989

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SENATE OFFICE OF RESEARCH
1100 J STREET, SUITE 650
SACRAMENTO, CALIFORNIA 95814
(916) 445-1727

California State Senate

ADVISORY COMMISSION ON COST CONTROL IN STATE GOVERNMENT

MILTON G. GORDON
CHAIRMAN

February, 1989

Honorable David Roberti
Chairman
Senate Rules Committee
Room 400, State Capitol

Dear Senator Roberti:

The Senate Advisory Commission on Cost Control in State Government herewith transmits its third report to the Senate Rules Committee -- a report on The State's Regulation of Financial Institutions.

This study was undertaken by a subcommittee of the Commission chaired by M. Larry Lawrence. The work of the Subcommittee was reviewed and approved by the Commission at its last meeting.

Members of the Subcommittee were Jerry Aspland, Carl Blomquist, and Phil Creaser. The Commission wishes to express its gratitude to John B. McNeece III and A. Vincent Siciliano, pro bono consultants to the Commission, for their contributions to the research and preparation of this report. In addition, the Commission wishes to thank Elisabeth Kersten, Jeremy Olsan, Richard Damm and Jason Warburg of the Senate Office of Research for their assistance in producing the report.

Very truly yours,

Milton G. Gordon

MILTON G. GORDON, Chair
Senate Advisory Commission on
Cost Control in State Government

MGG/jcw
Enclosure

REPORT ON

THE STATE'S REGULATION OF FINANCIAL INSTITUTIONS

of

The Senate Advisory Commission on Cost Control
in State Government

Subcommittee on Financial Institutions

Chair: M. Larry Lawrence

Members: Jerry A. Aspland
Carl A. Blomquist
Phil Creaser

Senate Advisory Commission on Cost Control in State Government

Chair: Milton G. Gordon

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A. Alan Post
Manning J. Post
Thomas E. Rankin
Diane N. Starr
Daniel Van Voorhis

Staff Consultants: Jeremy L. Olsan, Senate Office of Research
Jason C. Warburg, Senate Office of Research

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EXECUTIVE SUMMARY

Banks and savings and loans have failed at an unprecedented rate over the past five years. The recent upheavals in the financial services industry are seen by some as threatening the stability of our entire financial system. In order to minimize the adverse effects of these upheavals on California, the State needs to take on an aggressive reform program aimed at strengthening the supervisory abilities of our financial regulatory agencies.

Over the past decade there has been substantial deregulation of the financial services industry and changes in the financial services business, factors which have put increasing competitive pressure on banks and savings and loans. In addition, the large number of institutional failures over the past few years has created major problems for the federal insurance funds and the industry as a whole. The Commission believes that the time has come to evaluate whether banks and savings and loans have too many powers. It is apparent that deregulation has invited abuses and mismanagement. The Legislature should review its deregulatory actions and determine whether the law should be changed. This decision should be based on what is good for the citizens of California, not the preferences of the industry.

The significant changes that have taken place in the financial industry in recent years have made the supervision of financial institutions both more important and more difficult. The State needs to take steps to improve the supervisory capabilities of the Departments of Banking and Savings and Loan.

State Banking Department

As of February 1988, the State Banking Department was responsible for supervising 389 institutions and a total of $265 billion in assets. The Department has adopted a plan for meeting its regulatory objectives known as "Strategic Plan '88," and has a sound set of goals under that plan. Nevertheless, 37% of the banks regulated by the Department are in sufficient trouble to be placed on the Department's "problem" list. The recommendations of the Commission with regard to the Banking Department, discussed in detail in the body of the report, are summarized below:

- That the Legislature and the Department re-evaluate whether the Department's existing resources allow it to adequately supervise its licensees;

- That the Department take a number of steps to respond to recent findings that the principal causes for bank failure are fraud and misconduct;

- That the Legislature and the Department focus greater staff resources on dealing with bank fraud, including creating and fully staffing a special fraud unit within the Department;

- That the Department examine all licensee institutions at least once a year, and institutions it designates as "troubled" every six months;

- That the Legislature and the Department consider all appropriate means of providing salaries and benefits to examiners and supervisory staff comparable to private sector equivalents;

- That the Department fully implement recommendations from the Department of Personnel Administration (DPA) regarding improving examiner salaries and benefits, request additional authority from DPA for filling and reclassifying certain examiner classes, and reassess whether its career counseling program is meeting the needs of its employees;

- That the Legislature provide to the Department a $100,000 appropriation to increase examiner training which was cut from the 1988-89 budget; and

- That the Department conduct a thorough review of its sources of information and negotiate greater access to federal information sources.

Department of Savings and Loan

As of the close of 1987, the Department of Savings and Loan supervised 137 state-chartered savings and loans with $147.9 billion in assets. The Department does not have an overall strategy for its regulatory program and appears to have an inadequate number of examiners in light of the industry's problems. It has had to operate under some significant fiscal and operational constraints. But with the Savings and Loan industry in turmoil, the Department needs to take more creative and decisive steps to deal with the problems which confront it. The recommendations of the Commission with regard to the Savings and Loan Department, discussed in detail in the body of the report, are summarized below:

- That, inasmuch as the current system of the Department assessing funds from the Savings and Loans which it regulates is fundamentally flawed, the Legislature revise the Department's funding mechanism, by either mandating larger assessments to support the Department, funding the Department through the General Fund to provide budget flexibility and the possibility of General fund monies supplementing assessment proceeds, or by some other method such as franchise tax offsets;

- That the Department develop an operational strategy along the lines of the Banking Department's "Strategic Plan '88";

- That the Legislature and the Department create and fully staff a fraud unit within the Department, as recommended to the Banking Department above;

- That the Department examine all licensee institutions at least once a year, and institutions it designates as "troubled" every six months;

- That the Legislature further shield the the Savings and Loan Commissioner from political pressures by changing the office from a pleasure appointment to a term appointment removable only for serious cause;

- That the Department carry out joint examinations with the Federal Home Loan Bank of San Francisco where the Department focuses on operating areas unique to California institutions;

- That the Department adopt personnel reforms similar to those recommended for the Banking Department above in the areas of hiring, compensation, training and career counseling; and

- That the Department seek out additional information sources, as recommended to the Banking Department above.

The Commission does not believe that a recommendation to consolidate the State's financial regulatory functions into a "Department of Financial Institutions" is warranted at this time. While the idea deserves further study, at present there are substantial differences in the Departments of Banking and Savings and Loan's regulatory structures, and in the way each uses and trains examiners. Finally, based on the experience in other states, the administrative cost savings potential of consolidation does not appear to justify such a recommendation at this time.

Nevertheless, the entire area of regulation of financial institutions should have a higher profile in state government. The Governor and his administration must make this a high priority and assure that energy and resources are focused on the very serious problems outlined in this report.

PREFACE

The Senate Advisory Commission on Cost Control in State Government was created by Senate Resolution 40 (Roberti, 1984) to study, analyze, and make recommendations on cost control in state government. SR 40 directed the Commission to look for ways to increase efficiency, reduce costs, enhance administrative accountability and control, and apply improved program management techniques and systems to state operations. Like the federal Grace Commission, the Commission has been directed by SR 40 to forge private and public sector efforts to control the costs of and increase the efficiency of government.

The mission statement adopted by the Commission further defines project selection criteria: the study "should potentially effect improvements in multiple agencies..." and "improve services and / or programs permitting them to operate more effectively within existing resource levels."

With these goals in mind, the Commission selected for its third topic of analysis the regulation of California's financial institutions.

The Commission is indebted to John B. McNeece III and A. Vincent Siciliano for the many hours of toil and effort which they donated to the Senate in working on this project.

INTRODUCTION AND PURPOSE OF STUDY

1. Introduction

The tremendous challenges ahead for California's regulators of financial institutions demand a careful examination of their current status. The crisis in the financial industry, especially in the savings and loan area, has been building for years and shows no signs of abating. Estimates of the amount which the 101st Congress will have to appropriate to bail out the numerous failed and failing S & Ls throughout the country continue to rise, ranging from $20 billion to as high as $85 billion.[1]

But federal bailouts address only the immediate consequences of institutional failure. The challenge for regulators in California, as at the federal level, is to try to find and correct the problems in the regulatory system which permitted the failures to occur in the first place. The State must look to the future and determine how it can improve the ability of its regulatory institutions to lessen the impact of the ongoing upheavals in the financial industry.

There is much at stake for California in attempting to isolate and solve these problems. According to the State's Department of Banking, 37% of the banks chartered in California as of March 1988 were judged to be in less than satisfactory financial condition, with about 17% in serious trouble. The Department of Savings and Loan reported that 42% of the examinations conducted by the Department during the 1986-87 fiscal year were considered "problem" exams. For 1986 and 1987, failures by California S & Ls comprised almost 30% of the total national S & L failures.[2] The recent bailout and merger of American Savings and Loan of Stockton alone cost $2 billion, and the institution is still far from being out of trouble.

Clearly, a sense of urgency is called for. The ability of California to build on its economic successes will depend in large part on the stability of its financial system. The Commission has pursued this study in hopes of offering constructive recommendations on how the state's regulatory institutions might more effectively use their resources to cope with the challenges they face today and will face in the future.

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[1] Sacramento Bee, September 22, 1988, p. A1; Los Angeles Times, December 15, 1988, Part IV, p. 1.

[2] State Departments of Banking and Savings and Loan; FSLIC.

2. Purpose of Study

The purpose of this study is to review the supervisory role and capabilities of the California State Banking Department and the California Department of Savings and Loan, and to offer recommendations for strengthening the supervisory capabilities of the two departments.

A major theme in the regulation of financial institutions is that "(t)he role of a financial system carries a public or fiduciary responsibility" which validates "a government role in guiding the system."[3] The financial institutions within the jurisdiction of the State Banking Department and the Department of Savings and Loan have an enormous impact on the economy of California. As of February 8, 1988, the State Banking Department was responsible for supervising 280 state-chartered banks with $92 billion in assets, 100 foreign banking corporations with $66 billion in assets, and 19 trust companies within supervised banks holding $107 billion in fiduciary assets.[4] As of December 31, 1987, the Department of Savings and Loan supervised 137 state-chartered savings and loans with $147.9 billion in assets.[5] A major responsibility of the two departments is to protect the safety and soundness of the financial institutions under their respective jurisdictions. This serves to protect the public from losses due to institutional failures, and to protect the entire financial system.

The Commission believes that over the long run, costs to the State and the public can be reduced by strengthening state regulatory agencies such as the State Banking Department and the Department of Savings and Loan. This is by no means the entire answer, but it is still an important step.

We do not recommend here specific changes in the current statutory framework for the regulation of the state's financial institutions. However, we do believe that the severity of the current situation in the industry demands that the Legislature evaluate whether financial institutions in California have too many powers. It is clear that the expansion of powers the industry has experienced over the past ten years has invited abuses and mismanagement. The state should review current law

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[3] Henry Kaufman, Salomon Brothers, Speech to The U.S. Senate Committee on Banking, July 1987.

[4] Howard Gould, California Superintendent of Banks, "Background Paper on The Operations of The State Banking Department," February 8, 1988.

[5] Letter, Department of Savings and Loan to The Commission, February 18, 1988.

in this area and make a determination as to whether the law should be changed. Any changes should be based on the good of the state and its citizens, and not on the desires of the industry.

The Commission further believes that the supervisory functions carried out by the State Banking Department and the Department of Savings and Loan, always important for the protection of the public and the financial system of California, have become even more critical since the onset of deregulation. The supervisory capabilities of the two departments can and should be enhanced.

ORGANIZATION OF STUDY

This study will first present a statement of the context in which the State Banking Department and the Department of Savings and Loan must carry out their supervisory function. This includes major regulatory changes over the past decade, significant changes within the financial services industry, and the large numbers of institutional failures. These factors make the supervisory function increasingly important, yet at the same time increasingly difficult. The study then reviews the operations of the State Banking Department and the Department of Savings and Loans and provides a number of strong recommendations for enhancing the supervisory capabilities of these Departments. The study closes with comments concerning the possible consolidation of the two departments.

THE CONTEXT OF STATE REGULATION

Over the past decade, there have been substantial changes in the regulatory framework affecting financial institutions and in the financial services business. There have also been a large number of institutional failures, which have created major problems for the federal insurance funds and for the financial services industry as a whole. These changes have made the supervisory task of the State Banking Department and the Department of Savings and Loan much more important, but also much more difficult.

1. DEREGULATION

Legislation passed in the 1930s, augmented by restraints implemented by the federal regulatory authorities, established a regime of limited competition among financial institutions, which included (1) limitations on deposit interest rates, (2) restrictions on the financial products that banks and savings and loans could offer, and (3) geographical restrictions. Under the pressure of technological change and competition from non-bank businesses, this regulatory regime began to erode in the 1960's, and crumbled more rapidly in the 1970's and 1980's.[6]

Demise of Interest Rate Controls

In 1933, Congress gave the Federal Reserve the authority to set interest rate ceilings on time and savings deposits. These interest rate ceilings gave financial institutions a protected low-interest-rate source of funding. When high inflation in the mid-1970's and the early 1980's led to double-digit interest rates, above the ceilings, securities firms and insurance companies began to offer investment vehicles which paid market interest rates and which served as alternatives to deposit accounts. The new investment vehicles included negotiable order of withdrawal ("NOW") accounts, money market mutual funds ("MMFs"), and cash management accounts ("CMAs"), which were introduced by Merrill Lynch in 1978. The public responded with a large-scale movement of funds from deposit accounts to the new investment vehicles. For example, funds invested in MMFs increased from $3 billion in 1977 to $233 billion in 1982.[7]

With financial institutions under pressure from these developments, Congress began to dismantle the rate ceilings. In the Depository Institutions Deregulation and Monetary Control

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[6] See generally R. Litan, What Should Banks Do?, Brookings 1987, chapter 2.

[7] Ibid. at p. 34.

Act of 1980 ("DIDMCA"), Congress authorized banks and savings and loans to offer NOW accounts to individuals, and established the Depository Institutions Deregulation Committee ("DIDC"), which was directed to phase out interest rate ceilings by 1986. Subsequently, in the Garn-St. Germain Depository Institutions Act of 1982 ("Garn-St. Germain Act"), Congress directed the DIDC to accelerate the removal of interest rate ceilings, which it did with the creation of money market deposit accounts ("MMDAs") and superNOW accounts. This finally provided effective competition for the new investment products, and successfully stopped the growth of MMFs.

Product Expansion

While the deregulation of deposit accounts allowed depository institutions to compete with the new investment products and to hold onto their depository base, it also raised the cost of funds above the interest rate ceilings which had previously been imposed. This made it imperative for financial institutions to find assets which would provide rates of return above the cost of funds. Savings and loans, in particular, were under substantial pressure to increase their return on assets because of their large portfolios of low interest rate fixed mortgages.

Because savings and loans found the greatest difficulties with the deregulation of liabilities, i.e. deposit accounts, the savings industry received the greatest emphasis on the deregulation of assets. The Federal Home Loan Bank Board ("FHLBB") in 1979 and 1980 allowed federal savings and loans to offer variable rate mortgages ("VRMs") and renegotiated rate mortgages ("RRMs")[8] California savings and loans obtained the right to sell variable rate mortgages in the mid-1970s.[9] However, both VRMs and RRMs had limited flexibility. In 1980, Congress, through the DIDMCA, permanently suspended state mortgage rate ceilings. The DIDMCA also gave federal savings and loans the power to hold up to 20 percent of their assets in consumer loans, offer trust services and credit cards, and make second mortgages.[10]

With the Garn-St. Germain Act of 1982, Congress authorized federal savings and loans to make more consumer loans, make limited amounts of commercial loans, own property to lease,

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[8] D. Kidwell, R. Peterson, Financial Institutions, Markets and Money, 1984, at p. 281.

[9] Ibid. at 462.

[10] Ibid. at 281, 282.

acquire municipal securities and generally increase the diversity of their assets.[11]

In 1983, the California Legislature restructured the law regulating California-chartered savings and loans. The new law, passed with substantial input from the savings and loan industry,[12] gave much broader asset powers and much greater flexibility to savings and loans. To the California industry, this meant that having a California-chartered association could compete on a more equal footing with other financial service providers in the state who were not regulated by a state agency. At the same time, many observers felt that this added up to making savings and loans into fundamentally different institutions than they had been when the industry was created. Regardless, the result of this restructuring of the law was that California-chartered savings and loans increased from 106 associations in 1982 to the current level of 137 associations.[13]

Banks gained some power to expand products through the Garn-St. Germain Act of 1982, which gave banks more power to form subsidiaries.[14] National banks and affiliates of bank holding companies also obtained some additional powers through regulations and administrative interpretations promulgated by the U.S. Comptroller of the Currency and the Federal Reserve Board.[15]

The banking industry has made a concerted effort to expand its ability to participate in the securities business. The barrier has been the Glass-Steagall Act, a law passed in 1933 in order to separate commercial banking and the securities business. Through favorable interpretations from the Comptroller of the Currency and the Federal Reserve Board, upheld by the courts, bank affiliates have been permitted to engage in discount brokerage, private placement of commercial paper (short term corporate debt), and the underwriting of municipal revenue bonds, mortgage-related securities, consumer receivables related securities and commercial paper, subject to

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[11] Ibid. at 282.

[12] See Memorandum, David K. Milton, California League of Savings Institutions, "Source Derivation -- Commentary for Savings Association Law Recodification (AB 1434, Bane, Chapter 1091, 1983 Statutes)", November 22, 1983.

[13] Letter to The Commission from Department of Savings and Loan, May 19, 1988.

[14] R. Kidwell, R. Peterson, Financial Institutions, Markets and Money, at p. 129.

[15] R. Litan, What Should Banks Do?, at p. 51-54.

certain volume limitations. Banks, however, have not succeeded in obtaining the repeal of the Glass-Steagall Act, which would allow them to provide a full range of securities services.

Geographical Expansion

Financial institutions have traditionally been limited geographically to a single state. This restriction was contained in federal banking laws and in federal regulatory policy. However, historically there has been substantial pressure from banks to find a way to expand geographically in order to obtain new sources of deposits and lending opportunities.

Banks obtained expansion opportunities through the Garn-St. Germain Act in 1982, which allowed them to enter interstate banking by acquiring failed savings and loans and through "non-bank banks," institutions which took advantage of a loophole in the Bank Holding Company Act by taking on many banking functions without calling themselves a bank. Finally, through other provisions of the Bank Holding Company Act, banks obtained the rights to enter interstate banking by obtaining state authorization to do so. After the U.S. Supreme Court approved this strategy in a 1985 case, many states adopted laws which permitted banks or savings and loans, or their holding companies, either in a given region or nationwide, to come into the state, often subject to a requirement of reciprocity.

In California, the Legislature adopted interstate banking legislation in 1986 which permitted (1) expansion into California by banks and savings and loans from specified western states on and after July 1, 1987, and (2) expansion into California by banks and savings and loans from all states, on and after January 1, 1991, subject in both cases to a reciprocity requirement.

Deregulation: Goals and Results

The expansion of powers and geographical expansion described above went forward in the name of deregulation. It was argued that deregulation would enhance competition in the financial services industry, thereby resulting in a more efficient allocation of money and services, and benefits to consumers through higher interest on deposits and lower interest on loans. Proponents also suggested that deregulation would lead to "self-regulation" among financial institutions, that the financial services industry would police itself in the interests of maintaining consumer confidence and profitability, and that the demise of weak or poorly-managed institutions would leave the industry stronger and the public's monies safer.

The debate will continue as to whether deregulation has achieved the goals Congress had intended and the industry had lobbied for. Without question, it has opened up markets for new financial services businesses and allowed established financial institutions to offer a much wider array of products in order for them to remain competitive with other financial service providers. At the same time, deregulation has put the financial services industry under competitive pressure which it did not face before. We can make two conclusions about deregulation: (1) It has blurred the traditional institutional lines between banks, savings and loans, and other financial service providers. (2) It has allowed industry competition to increase. Unfortunately, one consequence of the increased competition is that many banks and savings and loans have undertaken questionable actions to increase profits or simply to maintain solvency. A recent congressional study found that misconduct caused or contributed to "at least one-third (and probably more) of commercial bank failures and over three-quarters of all S&L insolvencies.[16] Deregulation has clearly contributed to this development by making it easier for financial institutions to get into trouble, whether through mismanagement or outright fraud.

2. <u>BUSINESS DEVELOPMENTS IN THE BANKING AND SAVINGS AND LOAN INDUSTRIES</u>

Banks have come under significant pressure as a result of competition from other financial service providers. For example, banks have lost a significant portion of traditional short and medium term business lending to the securities markets. To a significant extent, the issuance of commercial paper and other securities has taken the place of commercial bank borrowing for major businesses.[17] The decline in lending opportunities has caused banks, in some instances, to lend to more risky enterprises. It has also put banks under pressure to expand their product offerings and to expand geographically in order to make up for lost lending. Riskier lending and new products, if not properly managed, can increase the general risk level for banks, raising safety and soundness concerns.

More broadly, banks are now facing intense competition from non-banking and even non-financial firms. American Express, Merrill Lynch and Prudential-Bache, for example, provide depository, lending and investment services, while the finance subsidiaries of such companies as General Motors and General Electric are competing in residential finance. Reflecting this competition, commercial banks' percentage of all assets held by

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[16] "Combating Fraud, Abuse, and Misconduct in the Nation's Financial Institutions: Current Federal Efforts are Inadequate;" Report of the Committee on Government Operations of the U.S. House of Representatives; October 13, 1988; p. 10.

[17] R. Litan, <u>What Should Banks Do?</u>, at pp. 42-43.

American financial institutions (excluding trusts) has fallen significantly over the last 40 years.[18]

Savings and loans have also faced changes in their core business.[19] Because of the deregulation of interest rates on time and savings deposits, the cost of funds is higher. With the deregulation of assets, savings and loans have attempted to enter new investment areas with potentially high returns, but with corresponding high risks. Real estate development and commercial real estate lending, for example, have provided sizeable profits for some, but huge losses for others, particularly in Texas and the Southwest. Even more conservative institutions are facing a profit squeeze because of narrow spreads between the cost of funds and mortgage rates, which are subject to downward pressure because of intense competition, fostered in part by the growth of the secondary mortgage market.

Savings and loans have also been forced to develop new strategies in response to interest rate volatility. Without careful attention to portfolio management, savings and loans suffer a risk of reduced spreads as well as a reduction in the market value of portfolios when interest rates rise. This has make it necessary for savings and loans to be much more sophisticated in terms of managing their assets and liabilities, to control interest rate risk. The new environment requires a high degree of skill and imposes great costs on those who do not manage properly.

These circumstances in the savings and loan industry have created two industries, one healthy and one dead or dying. The healthy industry, the much larger component of all savings and loans, has recognized the new realities and has adjusted. It is under pressure, but it is surviving. The dead or dying industry, through excessive risk-taking, criminal fraud, and other forms of misconduct, has become hopelessly insolvent and is dragging down all savings and loans.

3. INDUSTRY PERFORMANCE AND THE INSURANCE FUNDS

One clear indicator that the banking industry has suffered over the last decade is the fact that the aggregate volume of loan losses has increased dramatically since 1980. Profits for the banking industry as a whole declined from over 14 percent of

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[18] Ibid. at 44-45.

[19] See U.S. General Accounting Office, Thrift Industry, Trends in Thrift Industry Performance, December 1977 through June 1987 (GAO/GGD-88-87BR), May 1988.

equity in the late 1970s to 11.3 percent in 1985.[20] There have also been a large number of bank failures.

The savings and loan business has been even harder hit, primarily because of the dead or dying portion of the business. On Friday, July 22, 1988, the media reported that the nation's 3,126 savings and loans lost a combined $3.7 billion during the first three months of 1988 -- the largest quarterly loss in savings and loans' history. While more than two-thirds of all savings and loans remained profitable during the quarter, the 958 unprofitable associations, mostly in Texas (and other Southwest states, including California), lost a total of $5.1 billion. This loss offset the total earnings of profitable savings and loan in the country, $1.4 billion. Texas associations alone reported $3.5 billion of the total $5.1 billion lost on the quarter.[21]

Table 1 below summarizes the total bank and savings and loan failures in California and throughout the nation from 1983 to 1987.

Table 1

BANK AND SAVINGS AND LOAN FAILURES
CALIFORNIA AND NATIONWIDE

Year	Bank Failures California	Bank Failures US	Savings and Loan Failures California	Savings and Loan Failures US
1987	5	184	12	48
1986	2	138	15	49
1985	6	120	2	34
1984	5	79	1	27
1983	4	48	0	53

(Source: California State Banking Department, FDIC, California Savings and Loan Department, FSLIC)

Although complete figures for 1988 were not yet available at press time for this report, as of November 17, 1988, 185 banks and 143 savings and loans had failed nationally during 1988, indicating a leveling-off in bank failures, but an accelerating crisis for the savings and loan industry.

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20 R. Litan, What Should Banks Do?, at p. 101.

21 Sacramento Bee, July 22, 1988, p. C8.

This rash of institutional failures has created major problems. While losses to individuals have been minimized due to the federal insurance funds, the insurance funds themselves have been placed under pressure. The FSLIC, in particular, has been hard hit by savings and loan failures. According to the U.S. General Accounting Office, the FSLIC at December 31, 1987, had a deficit in the insurance fund of $13.6 billion. This reflected a $17.4 billion liability for the expected resolution costs with respect to institutions for which the FSLIC had assumed responsibility as of December 31, 1987, and did not include estimated resolution costs for another 300 institutions which were insolvent as of that date, according to generally accepted accounting principles.[22] Estimates for the total cost to the federal government of the current savings and loan insolvencies run as high as $70 billion.

Apart from the problems of the insurance funds, the financial services industry as a whole has been adversely affected by the institutional failures. First, weak institutions, relying upon their deposit insurance, have bid up the cost of deposit funds, thereby increasing the cost of funds for all institutions. More broadly, investor confidence has been shaken, affecting the cost of non-deposit funds and stock prices. For savings and loans, insurance premiums have gone up, cutting into profits. Finally, in some cases, failing institutions have brought down or weakened other institutions which maintained correspondent relationships or other business dealings with the failed institution.

4. STATE FINANCIAL SUPERVISION IN THE ERA OF DEREGULATION

In this era of deregulation, where the differences between banks, savings and loans, credit unions, securities dealers, insurance companies, and finance companies are less and less apparent even to the regulators themselves, the role of the state's financial regulatory departments has become vitally important, not only to the consumer, whose deposits it is the regulators' purpose to protect, but also to the health of the industry, which is in its deepest crisis in recent times.

While the State Legislature has been deregulating financial services and opening California to interstate banking, little attention has been paid to the best way to manage California's regulatory agencies in light of these changes. Despite the increasing complexity of financial relationships between and among institutions and their regulators, the proliferation of new services, the opening of California to interstate banking, and the impending sense among many that an economic downturn in the

[22] Report of the U.S. General Accounting Office to The Senate Banking Committee, May, 1988.

state could cause serious damage to the state's financial services industry, there have been relatively few serious attempts, outside of the Departments themselves, to ascertain how the State Banking Department and the Department of Savings and Loan are performing their statutorily mandated supervisory duties. This has occurred in spite of the fact that as deregulation progressed, supervision of institutions became more rather than less important, because of the increased opportunities for overextension and outright fraud on the part of institution officers. This study hopes to make a contribution in reviewing this important area.

STATE BANKING DEPARTMENT

1. Legal Mandate

The primary responsibility of the State Banking Department is to protect the public from economic losses that may result when a bank or a trust company fails. Banks have the option of being supervised by federal regulators or by the state. Only state chartered banks are regulated by the Department. In addition to encouraging observance of safe and sound banking practices, the Department regulates (1) issuers of payment instruments; (2) issuers of traveler's checks, and (3) Business and Industrial Developments Corporations (BIDCO's). The Department also certifies securities for the State of California, municipalities, and other government agencies within the State as legal investments. Table 2 shows the number of banks regulated by the Department from 1980 through 1987.

Table 2

BANKS AND BRANCHES REGULATED BY THE STATE BANKING DEPARTMENT, 1980 - 1987

Year End	State Chartered Banks	Branches
1987	279	1716
1986	287	1685
1985	285	na
1984	286	na
1983	273	na
1982	264	na
1981	252	na
1980	223	na

(Source: State Banking Department)

The banks represented above held $92 billion in assets in 1987. In addition to banks, the Department supervises 100 foreign banking corporations with $66 billion in assets; and 19 trust companies and 42 trust departments within supervised banks holding $107 billion in fiduciary assets.

2. Funding and Staffing

The operations of the State Banking Department are supported by the State Banking Fund, which is replenished annually by assessment of banks, issuers of money orders and travelers checks, and trust companies; license and application fees; sale of publications; and charges for specific services, such as bank examinations.

The Department is administered by the Superintendent of Banks, who is appointed by the Governor. In the 1987-88 Fiscal Year, the Department has a staff of 182 personnel-years.[23] Table 3 summarizes the supervisory staffing of the department from 1982 through 1987.

Table 3

NUMBER OF BANK EXAMINERS AND SUPERVISORS, 1982 - 1987

	Field Examiners				Total
	Allocated	Staffed	Assistant Deputies	Regional Deputies	Supervisorial Staff
1987	118	112	8	4	124
1986	117	106	7	4	117
1985	116	108	7	4	119
1984	116	109	7	4	120
1983	109	103	7	4	114
1982	103	97	7	4	108

(Source: State Banking Department and Legislative Analyst)

Table 4 below shows the number and type of examinations performed by the Department from 1980 - 1987. The Department examines the operations of foreign banking corporations and trust companies, as well as performing separate examinations of the trust departments of banks. From the data below, the Department examines each institution roughly every other year. Problem banks are supervised more stringently, with examinations occurring more often.

[23] Legislative Analyst and The State Banking Department. "Personnel-years" refers to the total number of full-time positions allocated to a department, regardless of how work is broken down in practice.

Table 4

EXAMINATIONS PERFORMED BY THE BANKING DEPARTMENT, BY INSTITUTIONAL TYPE, 1980 - 1987

	Banks		FBC's*		Trusts	
Year	Number	Examined	Number	Examined	Number	Examined
1987	279	177	102	50	63	17
1986	287	173	100	53	62	29
1985	285	177	99	57	61	27
1984	286	147	102	50	61	30
1983	273	141	101	46	53	24
1982	264	140	97	44	52	20
1981	252	143	92	32	50	22
1980	223	147	90	34	34	20

*Foreign Banking Corporations

(Source: State Banking Department)

3. Institutional Failure Trends in California

Table 5 summarizes the number of banking failures in California and throughout the nation from 1983 through 1987. Within California, only institutions under the column for "State" banks are under the jurisdiction of the State Banking Department. Table 6 gives a fuller picture of significant bank problems in California under the jurisdiction of the Department by showing bank failures and banks merged through regulatory enforcement action from 1983 through 1987. During the ten-year period before deregulation, from December 1971 until December 1981, only one state-licensed bank failed. Since January of 1982, over 23 state banks have failed.

Table 5

BANK FAILURES, FEDERAL VS. STATE CHARTERED INSTITUTIONS
1983 - 1988 YEAR TO DATE

Calendar Year	State Banks	National Banks	California Total	U.S. Total
1987	5	2	7	184
1986	2	5	7	138
1985	6*	1	7	120
1984	5	1	6	79
1983	4	1	5	48

* Does not include one office of a foreign banking corporation that failed in Canada, necessitating the liquidation of the California operation by the Superintendent.

(Source: State Banking Department; FDIC)

Table 6

FAILED AND MERGED BANKS REGULATED BY STATE BANKING DEPARTMENT
1983 - 1987

Year	Failed	Merger*	Total
1987	5	6	11
1986	2	3	5
1985	6	2	8
1984	5	4	9
1983	4	7	11

*Merged through regulatory enforcement action

(Source: State Banking Department)

According to the Banking Department, as of February 8, 1988, there are 45 state-chartered banks considered to be "serious problem situations" where, "unless corrections are effected, the bank could fail." The Department indicates that another 58 banks are considered to be in "less than satisfactory condition, although not quite as serious." Furthermore, "several" foreign banking corporations regulated by the Department are considered to be in less than satisfactory condition.[24] With 103 state-regulated institutions either on the "serious problem" list or the "problem" list, the State Banking Department is faced with a serious situation: 37%, more than 1 out of 3 state banks, are in trouble of some kind.

In a June 1988 study entitled "Bank Failure: an Evaluation of the Factors Contributing to the Failure of National Banks," the U.S. Comptroller of the Currency found that most failed banks had poor management. The study also found that most failed banks had inadequate systems to ensure compliance with internal policies or banking laws. About half of these banks had nonexistent or poorly followed asset and liability management policies. In more than half of the failed banks studied, one dominant individual made decisions.[25] Such conditions invite misconduct of all types, from poor management to criminal fraud. The recent congressional report on fraud in the financial industry found that "serious misconduct by senior insiders or outsiders has caused, or contributed to, or was present in, the insolvencies of most banks...at least one-third (and probably more) of commercial bank failures" are traceable to some form of misconduct.[26]

The problems enumerated above with regard to banks nationally are, to a great degree, the same problems that state-chartered banks have. The ability of the State Department of Banking to identify the specific reasons for banks' instability will result in more effective enforcement actions being taken.

4. Costs to the State of Bank Failures

The State Banking Department indicates that, aside from billings from the Attorney General's office and the relatively small amount of travel expenses associated with the resolution of failed banks, all costs incurred by the Department in this function are part of the normal salary and staff expenses of the department. As such, they are not accounted for in a separate category. Banking Department records do indicate, however, that

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[24] Howard Gould, Superintendent of Banks, "Background Paper on The Operations of The State Banking Department," February 8, 1988, at p. 13

[25] Remarks by Robert Clarke, Comptroller of The Currency, Press release #NR 88-41, June 20, 1988.

[26] "Combating Fraud, Abuse, and Misconduct in the Nation's Financial Institutions: Current Federal Efforts are Inadequate;" Report of the Committee on Government Operations of the U.S. House of Representatives; October 13, 1988; p. 10.

in 1986 and 1987, the department spent approximately 13,500 personnel hours on banking enforcement and closings.[27]

5. Strategic Plan '88

Overall, the State Banking Department appears to have clear objectives, substantial understanding of the conditions in the banking industry and the problems faced by the industry, and a sound plan for reaching its objectives, within the budget limits imposed by the Governor and the Legislature. The Department should be commended for its strategic plan, discussed below. Two key issues for the Banking Department will be whether they will effectively implement "Strategic Plan '88," and whether it has the resources to adequately supervise the banking industry, even with the efficient use of resources contemplated by the plan.

Earlier this year, Superintendent of Banks Howard Gould publicly presented the State Banking Department's "Strategic Plan '88 -- Adapting to a Changing Financial Services Environment." This is the first long-range plan ever undertaken by the Department to actively manage change in the financial services industry. The plan is realistically based on the assumption that, in addition to the multitude of changes already brought on by deregulation, there will be ongoing change -- that the banking business is no longer the staid and predictable enterprise it once was, especially when interstate banking begins in 1990.

The strategic plan also anticipates changes in industry performance, namely continued pressure for banks to remain profitable in an increasingly competitive environment. Industry changes will give banks more powers, creating "a need for the Department to supervise these increased powers effectively." The plan also considers changes in the California economy, citing population growth and California's position as a Pacific Rim finance center.

The strategic plan predicts that the Department's resources will not grow as fast as the complexity of the industry, and it promises to develop Department personnel at a faster pace and with better training to cope with the new challenges. To accomplish these goals, the Department's plan enumerates four specific objectives:

1) The Supervision Objective

2) The Human Resource Objective

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[27] Letter to The Commission from Howard Gould, Superintendent of Banks, March 1, 1988, p.1.

3) The Infrastructure Objective

4) The Information Objective

While the Commission commends the Department for developing a long-term strategic plan, it remains to be seen whether it will be implemented with as much success as it was created. The Department plans to update the strategic plan periodically to accommodate unanticipated events.

6. <u>Implementation of the Strategic Plan -- Supervision and Human Resources Objectives</u>

The supervision objective contained in the strategic plan stresses expanding the Department's reliance on examinations as the primary technique for bank supervision. While examinations will be the mainstay of supervision, the plan is to focus new attention on non-bank licensees: trust companies, issuers of payment instruments, traveler's checks, and BIDCO's. The financial analysis support strategy in the plan envisions developing financial analysis capability to allow for "effective off-site supervision and preparation for on-site examination allowing the supervision process to focus on those points most important to us as regulators."[28]

The Superintendent of Banks' response to Commission inquiries indicates that the Department has experienced "continued pressure in meeting our statutory obligations to examine licensees."[29] Superintendent Gould cites the annually increasing number of licensees and expanded banking powers since deregulation as the chief reasons for the Department's difficulty in meeting its duties.

In spite of indications that his management team has designed "several ways to combat these pressures over the next few years without the need for a substantial increase in staff," Superintendent Gould acknowledges that the Department could use 14 more examiner positions soon.[30] The new examination strategy proposed includes the following points:

1) "Focus Examinations," one of the first "action plans" to be implemented under the direction of "Strategic Plan '88."

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[28] State Banking Department "Strategic Plan '88," Executive Summary, p. 4.

[29] Howard Gould, Superintendent of Banks, "Background Paper on The Operations of The State Banking Department," February 8, 1988, p. 13.

[30] <u>Ibid</u>, p. 13.

2) Department agreement with the FDIC to jointly examine all banks having assets of $1 billion or more will further reduce examination time;

3) Internal office automation system (on-line by Fall of 1988).

4) Departmental reorganization plan, which will include a realignment of workload between the offices, possible reclassification of certain positions, and restructuring of the training and consumer complaint sections.[31]

In order to meet the Department's newly-established human resources objective, a new hiring strategy is being developed, and performance reviews will be based upon new and more explicit standards for each position.

RECOMMENDATIONS TO THE STATE BANKING DEPARTMENT*

Guided by its new "Strategic Plan '88," the Department may be able to anticipate change and react, while maintaining the high standards in personnel and performance to regulate banks during these volatile economic times. The following recommendations relating to the implementation of the strategic plan will be of help:

Supervision Objective

RECOMMENDATION 1 - Adequacy of Resources.

Although the Department contemplates efficient and effective deployment of its resources, it is still the case that since January 1982, 23 state banks have failed. In addition, Superintendent Gould reports that as of February 1988, there are 45 state-licensed "serious problem banks" where, unless corrections are effected immediately, the banks may fail. Another 58 banks are in less than satisfactory condition, although "not quite as serious." **Altogether, 37%, more than 1 out of 3 state banks, are in trouble of some kind. At the same time, Superintendent Gould has acknowledged that the Department is in need of additional personnel, including 14 new examiner positions. The Legislature and the Department must evaluate whether even with effective and efficient deployment of resources, the Department has enough resources to adequately supervise its licensees.**

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[31] Ibid., pp. 13-15.

* NOTE: Recommendations 1 - 12 deal with the State Banking Department, while Recommendations 13 - 20 are addressed to the Department of Savings and Loan.

RECOMMENDATION 2 - Focus on Reasons for Failure.

Recently, the U.S. Comptroller of the Currency completed an eight-year study concerning the key reasons for bank failure. The Report blamed poor management for the majority of bank failures. The recent congressional report investigating misconduct in the industry found that "at least one-third" and probably more of all commercial bank failures are traceable to misconduct of some variety. **The Department should carefully review the findings of these two important studies regarding the reasons for bank failure and take steps to ensure that each bank that they supervise has internal policies and procedures aimed at curbing fraud and misconduct. Furthermore, the Department should ensure in its supervisory role that each bank adheres to those policies and procedures, including dedicating substantial resources to internal compliance measures.**

RECOMMENDATION 3 - Fraud.

Both the Comptroller's Report and the recent congressional report indicate that fraud is a factor in approximately one third of all bank failures. The Department has kept abreast of these investigations and has taken steps to develop a coordinated response to fraud with other enforcement agencies. The Department supported SB 1024 (Vuich), which permits state financial services regulatory agencies to exchange information on licensing and certification investigations and investigations of unlawful activities with law enforcement and federal agencies. The Department is also represented on the State's White Collar Crime Task Force, which meets every two months to "exchange information and discuss common issues." **The Department should review and implement additional steps for improving its ability to detect and respond to bank fraud, including planning for the establishment of a fraud unit as recommended under Recommendation 9. The Legislature and the Department should jointly review the law and determine whether there is adequate legislation to deal with insider transactions, and whether the Department has enough support from criminal law enforcement agencies. The Department should evaluate whether a public Attorney General approach, where citizens who bring fraudulent activity to the attention of enforcement agencies are entitled to a percentage of any proceeds, would be an effective deterrent in the banking area.**

In addition, some members of the Commission felt strongly that jail sentences should be mandatory when officers of an institution are convicted of fraud or misconduct, and that upon their conviction, officers should also lose their pension and profit-sharing rights.

RECOMMENDATION 4 - More Frequent Examinations

The Department currently examines institutions roughly every other year, with smaller intervals between exams for troubled institutions. Given the turmoil in the industry and the fact that 37% of state-chartered banks are in trouble of some kind, we believe that this is an insufficient amount of supervision. **The Department should examine every one of its licensees at least once a year. "Troubled" institutions should be examined at least every six months.** Increasing the frequency of examinations should help the Department to detect problems earlier, as well as acting as a deterrent to those who might otherwise attempt fraud or other misconduct.

Human Resource Objective

The Department has suffered from a turnover of examiners and auditors. Significantly, 11.2% of all examiners and auditors (14 personnel) left the Department in 1985-86 and 13.8% (17 personnel) left in 1986-87. The Auditor General identified pay and benefits limitations and a lack of promotional opportunity as the primary causes for this high turnover. Steps have been taken to reduce turnover, but the Banking Department cannot attract and keep top examiner staff until salaries and benefits are comparable to the competition. Further steps must be taken to do more than simply reduce turnover. The Department must be able to offer better inducements than the federal government and remain within ball-park range of the private banks to lure away the top examiners and attract top new examiner trainees.

RECOMMENDATION 5 - Provide Pay Comparable to the Private Sector for Examiners and Supervisory Staff.

The Department and the Legislature should consider all appropriate means of providing salaries and benefits to examiners and supervisory staff comparable to private sector equivalents. It is worth noting in this regard that there is precedent for the removal of these positions from civil service pay scales. The California Public Employees Retirement System (PERS) and the State Teachers Retirement System (STRS), in efforts to stop the exodus to the private sector of the top investment managers and financial analysts who manage these public funds, were successful in pushing legislation that exempted these personnel from the state civil service pay scale. The FHLB of San Francisco, faced with the same problem as PERS and STRS, succeeded in removing its supervisory personnel from civil service, thereby permitting higher salaries and better benefits. Because a number of State Banking Department personnel have left for employment with the FHLB of San Francisco, the Legislature and the Department should consider taking similar steps. If such an exemption or any other pay-augmenting measures are enacted, however, with them should come a new and more stringent performance review system for these employees, so as to allow continued justification for paying them higher salaries.

RECOMMENDATION 6 - Personnel Salary Survey.

The Department of Personnel Administration, at the request of the Legislature, completed a survey in November of 1987 comparing wages, salaries, and benefits of examiner staffs at the Federal Home Loan Bank and Federal Reserve Bank in San Francisco, and the States of Michigan, New York, Ohio, Pennsylvania, and Texas to the compensation packages offered by the State of California's financial regulatory departments. The State Banking Department insists it made changes in its personnel policy prior to rather than as a result of the DPA survey. **The personnel policy changes made by the Department, however, occurred only because DPA reduced the barriers to examiners' advancement from the entry level to the journey level by combining examiner levels into single "deep classes" in which advancement is streamlined. According to information supplied by the Department, it has not availed itself of the four other new provisions created by DPA as a result of its survey. We recommend that the Department carefully evaluate the DPA report and conclusions and act accordingly in setting salaries and benefits.**

RECOMMENDATION 7 - Reclassifying of Examiner IV Positions.

DPA implemented the following recommendations of the Legislative Analyst to alleviate the turnover problem in the Departments of Banking and Savings and Loan: (1) to establish "deep classes" for examiners (see above for definition), and (2) for DPA to conduct the salary and benefit survey noted above. **DPA did not implement the third recommendation of the Analyst for DPA to delegate more authority to the Banking Department for filling and reclassifying Examiner IV positions. The commission calls on DPA to follow this recommendation. The Banking Department should raise this issue with DPA once again.**

RECOMMENDATION 8 - Counseling.

The Department has staff who can provide career counseling upon request. **The Department should evaluate whether it has an adequate counseling program for its employees, in order to maintain a close rapport with them and to assist them in further developing their capabilities and advancing their careers.**

RECOMMENDATION 9 - Training

According to Department officials, "lack of training has been a complaint from examiners for several years." However, a $100,000 appropriation to increase examiner training and to provide for a permanent departmental training officer was cut from the Governor's 1988-89 Budget. **In order for the Department to adequately train new staff and keep existing staff abreast of changes in their field, these funds must be restored.**

As deregulation allows banks to engage in non-traditional activities, examiners must develop skills to analyze these areas. The Department has designed a comprehensive in-house training program for all examiners to complement the current use of other regulators' schools and specialty banking schools, college courses, and in-house video training classes. The Commission believes this planned program is an excellent idea, and supports the use of other schools and tapes, but because the Department's examination function is, in the Department's own words, "pressured," we are unclear whether a fully-functional training program would be utilized by examiners under present conditions. **The Commission recommends that the training plan be implemented and fully funded, provided that examiner workload will allow maximum participation in the training program.**

Infrastructure Objective

RECOMMENDATION 10 - Fraud Unit.

The Department does not have a fraud unit. Two investigators, who may be given limited peace officer status by the passage of SB 2272 (Vuich), are currently in the budget for the upcoming Fiscal Year. These investigators would investigate various violations of law, including bank fraud, and enforce various laws administered by the Department. They would also investigate the backgrounds of persons applying for bank charters and other licenses issued by the Department. SB 2272 would allow these investigators to serve arrest warrants and have access to criminal records -- vital tools if they are to be effective in preparing cases that the Attorney General or local district attorneys will be willing to accept for prosecution. **The Commission fully endorses SB 2722, and concurs with the need for Departmental investigators.** However, much more is needed to effectively combat this serious problem.

In light of the findings that fraud and insider abuse are a major reason for bank failure, **the Department and the Legislature should work together to establish a special fraud unit, regardless of whether the investigator positions are funded or whether they receive peace officer status. The Commission believes that two investigators are not nearly enough, by themselves, to effectively address the fraud problem. A fraud unit, staffed by several full-time investigators, preferably with peace officer status, should also be staffed with its own secretarial support services and legal counsel.** It is possible that existing Department resources could be assigned on a part-time basis to accommodate these needs; if not, the Legislature should provide the Department with supplemental resources earmarked for this purpose. It is essential, to reduce the future cost of institutional failures to California taxpayers, for the Department to have a much better fraud detection and prevention capability than it has today.

Information Objective

RECOMMENDATION 11 - Focus on Problem Areas.

The Department should focus on the key problem areas in the banking industry which have been recently reported to be contributors to bank failure, particularly fraud and misconduct, in order to identify the types of information that would provide an early warning of potential failure. **The Department should then design and implement a strategy for maximizing its access to this type of information, including the use of investigators,**

shared information with federal regulators, and other potential information sources.

<u>RECOMMENDATION 12 - Access to Information</u>.

"The Department utilizes a quarterly report from each bank to analyze its present situation and to track its trends," say Department personnel.[32] The report gives the Department a balance sheet for the bank, along with earnings reports, maturity and delinquency schedules. According to the Department, supplemental schedules are attached to obtain information related to the expanded powers of banks, but federal regulators who also examine state banks use reports that provide more data in some areas. Considering the above, and the fact that some reports point to misconduct, **the Commission recommends that the Department negotiate a means to have access to these federal reports, and to access their Washington database. In areas where federal and state reports do not provide adequate information, the Department should obtain additional supplementary schedules from banks.**

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32 Letter to The Commission from Superintendent of Banking Howard Gould, May 20, 1988, p. 4.

DEPARTMENT OF SAVINGS AND LOAN

1. Legal Mandate

The Department of Savings and Loan is responsible for regulating the activities and examining the financial records of the state-licensed savings and loan associations in order to protect the savings and investments of the public. The Department's policy statement expands this mandate to include Department assurance of the "continued financial growth of these associations consistent with public need and convenience."[33] Table 7 shows the number of savings and loans regulated by the Department from fiscal year 1982-83 through fiscal year 1987-88.

Table 7

SAVINGS AND LOANS REGULATED BY THE DEPARTMENT, 1982 - 1988

Fiscal Year	State Chartered Savings and Loans	Branches
1987-88	137	1295
1986-87	146	na
1985-86	153	na
1984-85	148	na
1983-84	123	865
1982-83	106	665

(Sources: Department of Savings and Loan; Legislative Analyst)

Currently there is in excess of $147.9 billion in assets in the State associations represented above. Associations convert these funds into residential, consumer and commercial building development and construction loans.[34]

2. Funding

The operations of the Department of Savings and Loan are supported from the Savings Association Special Regulatory Fund, whose revenues come primarily from an annual assessment of savings and loans, based upon the association's assets. These funds go toward examinations and bank oversight only, and a contingency reserve for economic uncertainty is maintained. The

[33] Letter to The Commission from Shirley Thayer, Department of Savings and Loan, Senior Staff Counsel, February 18, 1988, p. 2.

[34] Governor's Budget, 1988-89, page BTH 61, line 8.

state's General Fund provides a small amount of additional administrative funding.

The Special Regulatory Fund's contingency reserve appears to be in jeopardy. In 1986-87, the reserve totaled $4,463,000. But by the next Budget Year, 1987-88, the reserve was almost halved to $2,489,000. In the coming year, the reserve is estimated to be a shrinking $2,319,000. Should the costs of examination, supervision, and enforcement rise in the coming years due to an increasing (and, experts say, predictable) number of association failures, this fund will be wiped out quickly. **The Department must work to address this situation immediately, or risk an inability to sustain its own operations during the time its expertise is needed most urgently.**[35] The Department determines the assessment for the Special Regulatory Fund annually, after consultation with representatives of the savings and loan industry. The Department should reconsider what is a "reasonable" amount for savings and loan to be assessed which would provide for increasing the reserve to at least its 1986-87 level.

The Commission feels that the manner in which the annual assessment is determined is fundamentally flawed. Whether the consultation between the Department and the industry is formal or informal is irrelevant. We are simply unaware of any other State regulator, funded by assessments against its licensees, which consults with its licensees to determine the fairness of its share of the regulator's operating costs. Were other state agencies determining their budgets in such fashion, particularly where the relationship between the agency and its licensees is quite comfortable, the simple appearance of collusion is far too blatant to inspire public trust in either the industry or the regulator. Section 8030 of the California Financial Code provides that:

> ...The commissioner shall require each association doing business to pay in advance an annual assessment for its pro rata share of all operating costs and expenses as estimated by the commissioner for the ensuing year.

Section 8030 of the Code is more specific:

> The proportion of operating costs and expenses to be assessed against each association shall be determined and prescribed by the commissioner by regulation.

Nowhere does it appear that the Financial Code provides for the Department's consultation with its licensees or their representatives.

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35 Data from The "Analysis of The 1988-89 Budget Bill," Legislative Analyst, February 24, 1988, pp. 213-216.

According to the Legislative Analyst and the Department, approximately 9% of the Department's annual budget is comprised of the annual assessment against the troubled American Savings and Loan Association, which has been placed in receivership by the FSLIC pending its sale to new investors. The prospective owners plan to switch to a federal charter, thereby depriving the Department of American Savings' substantial assessment. Another large association has expressed interest in changing its charter from that of a state-chartered savings and loan to that of a state-chartered bank. The Department's budget thus faces significant reduction and could be further adversely affected if the second association above were to exert pressure on the Department to decrease its assessment.

The scenario in which a California savings and loan changes charter to either a federal savings and loan or a bank is becoming more and more common. As savings and loan officers see fewer benefits from the California state charter, it makes less and less sense to them to pay the added costs of state regulation without offsetting gains in the form of broader powers. The threat of charter-shopping by savings and loan has exacerbated the funding and staffing problems the Department now faces. Its budget needs are being held hostage to regulatory competition.

Industry groups have put forth the argument that regulation by the state is duplicative. In addition to the Department of Savings and Loan, associations must be audited by independent auditors, in-house auditors, and the FSLIC on a regular basis. Each of those audits concentrates on different aspects of the association's operations, however, and the fact is that those institutions choose the state as a regulator, placing the state under the legal obligation to supervise them on behalf of the public. To the extent that regulation is necessary, the associations should be willing to both submit to examinations and pay for them.

3. Staffing and Examinations

Tables 8 and 9 below indicate that, in 1987, the Department of Savings and Loan employed a total of 83 examiner and supervisory personnel, amounting to one examination per staff person per year. In contrast, the State Banking Department's 116 examiners and assistant deputy examiners completed 177 bank examinations, 50 foreign banking corporation examinations, and 17 trust company examinations during 1987. (See Table 4, "Examinations Performed by the Department of Banking"). These figures do not suggest that savings and loan examiners are less productive than bank examiners. Indeed, the disparity between the requirements and current difficulty of savings and loan versus bank examinations make such comparisons of questionable value. Nonetheless, our intuitive conclusion is that additional examiners in the Department of Savings and Loan may be needed in order to increase the frequency and effectiveness of supervision.

Table 8

NUMBER OF SAVINGS AND LOAN EXAMINERS AND SUPERVISORS
1982 - 1987

Budget Year Ended	Examiners	Supervisors	Total
6/30/88	66	17	83
6/30/87	68	15	83
6/30/86	67	17	84
6/30/85	49	12	61
6/30/84	32	15	47
6/30/83	16	13	29

(Source: State Department of Savings and Loan)

Table 9

EXAMINATIONS PERFORMED BY THE DEPARTMENT, BY TYPE OF EXAMINATION
1983 - 1987

Budget Year Ended	Total Examinations	No. of Examinations	
		Regular	Problem
6/30/87	83	48	35
6/30/86	75	42	33
6/30/85	77	52	25
6/30/84	79	56	23
6/30/83	91	76	15

(Source: State Department of Savings and Loan)

Prelicensing examinations are included in the 1983 figures. Eighteen associations opened in 1983.

The Department points out that, "although the number of problem associations has decreased, the number of problem examinations has increased".[36] The data above indicates that, during a period when the number of associations being supervised rose by over 25 percent, and problem examinations increasing by more than 100 percent, the total number of examinations

[36] Letter from Shirley Thayer, Senior Staff Counsel, February 18, 1988, p. 4.

performed fell by almost 9 percent, from 91 exams in 1983 to 83 exams in 1987.

According to the 1988-89 Governor's Budget, the Department estimates that it will perform 131 examinations, utilizing a total of 333 field visits, in Budget Year 1987-88. This appears to indicate that the Department plans to examine each institution under its supervision no more than once a year. Considering the fact that the industry is in serious condition by most accounts, it would be prudent for the Department to step up the frequency and detail of its examinations. The Commission is concerned that, without hiring additional examiners who already have some expertise, the Department will not be able to meet its goals for the year, nor its overall legal mandate.

There is one more factor that should be noted in connection with extent of the Department's examination staff. A moratorium by the FSLIC on the licensing of new savings and loan in California, Texas, and Florida has been in effect since approximately 1984. The moratorium was reached by agreement with the Department. The provisions of the ban were that, until the savings and loan regulatory departments in these states could hire a sufficient number of examiners to adequately regulate associations, the FSLIC would not grant insurance to any new associations, thereby preventing them from being licensed by the states.

According to the California Department of Savings and Loan the moratorium is still in effect, although the Department says it reached the agreed-upon examiner staffing levels some time ago. Department officials are unaware of the reasons for the continued ban, and note that the FSLIC has provided insurance to new associations in Florida and Texas in recent months.

It is unclear why the FSLIC is still not granting insurance in California (the Department has not been openly critical of the continued ban), but if indeed one of the Department's principal objectives is "to assure the continued financial growth of these associations consistent with public need and convenience," it appears that in spite of raising the number of examiners (from 49 in 1984 when the moratorium began, to 66 in 1988), the Department knows it is under pressure and is not truly capable of effectively regulating any more associations than currently exists.

4. Institutional Failure Trends in California

Table 10 below summarizes the number of failures of California chartered savings and loans and total failures throughout the nation from 1983 through 1987. It is clear from these data that California associations are over-represented. For 1986 and 1987 California failures comprised 28% of the total national failures of savings and loans.

Table 10

SAVINGS AND LOAN FAILURES, CALIFORNIA-CHARTERED vs. TOTAL FAILED INSTITUTIONS, 1987-1988 YEAR TO DATE

Budget Year	California	Total
1987	12	48
1986	15	49
1985	2	34
1984	1	27
1983	-	53

(Sources: State Department of Savings and Loan; FSLIC)

Some experts suggest by way of explanation that the FSLIC may be more stringent, imposing more closings in California, simply because the California economy can afford it. They speculate that the assets held by troubled California associations can be disposed of faster and easier than in Texas or the Midwest, where the assets are so poor and the market so nonexistent that liquidation is difficult. Others disagree with this interpretation, saying that the majority of failed institutions are small ones, the assets of which are easy to sell off.

In examining the causes for savings and loan failures, the Department points to the less stringent law allowing "entrepreneurial," inexperienced, or outright criminal individuals or very small groups to hold control of savings and loan as the factor which ultimately has led to the growing number of failures in the state. As noted previously, a recent Congressional study concluded that fraud and misconduct accounted for over three-quarters of all savings and loan insolvencies. During the hearings which produced this report, California Savings and Loan Commissioner William J. Crawford, referring to the relative ease with which money may be stolen from a financial institution through insider fraud in congressional testimony on June 13, 1987, stated his view that "the best way to rob a bank (or savings and loan) is to own one."[37]

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[37] "Combating Fraud, Abuse, and Misconduct in the Nation's Financial Institutions: Current Federal Efforts are Inadequate;" Report of the Committee on Government Operations of the U.S. House of Representatives; October 13, 1988; p. 34.

Neglected in these discussions is an important historical note: the onset of deregulation failed to bring with it an increase in supervision. In fact, as financial institutions gained expanded powers, supervision stayed the same or even decreased, inviting abuses of these powers. A key reason for the crisis in the industry today is the fact that oversight of the industry did not increase either quantitatively or qualitatively during a period when institutional operations were becoming increasingly complex and perilous.

5. Costs to the State of Savings and Loan Association Failures

The annual costs to the State of savings and loan association failure are relatively insignificant on the whole, but as they relate to the total budget of the Department, the costs become more telling. As represented in Table 11 below, the total cost, from June 1982 to December 1987, to the Department of Savings and Loan of the sale, closure, merger or bailout of insolvent savings and loans, was $3,226,514. This includes factors such as attorney's fees and consulting fees. The costs are established from estimates of time spent directly and indirectly, including costs incurred prior to and work after as a result of conservatorship or receivership, except that the costs incurred by the examination section of the Department are only for the immediate cost related to the takeover (i.e., day of takeover and time on premises).

Costs of takeovers will, of course, vary depending on the circumstances and reasons for insolvency. Those takeovers which required legal actions also require extensive staff time to produce records, appraisals, and investigation for civil and criminal court filings. Some of these costs have extended into subsequent years and are reported here in the years incurred.

Table 11

COSTS ASSOCIATED WITH INSOLVENT SAVING AND LOAN ASSOCIATIONS BY THE DEPARTMENT OF SAVINGS AND LOAN, 1983 - 1988

*(For Associations placed in conservatorship or receivership)

Budget Year Ended	Number of Failed Associations	Total Estimated Cost
6/30/83	-	$ 20,343
6/30/84	1	133,837
6/30/85	2	487,462
6/30/86	15	1,014,621
6/30/87	12	993,417
6/30/88 (to 12/21/87)	1	576,834

*NOTE: The total cost for the entire period charted above is $3,226,514. These costs are only for those associations that have been placed in a conservatorship or receivership. The costs expended on other associations that pose significant problems exceeding the ordinary expected problems continue to impact significantly on the Department's resources.

(Source: State Department of Savings and Loan)

6. Eclipse of the Department

The sizeable problems faced by the Department are accompanied by a loss of clout. Put directly, the Department has been eclipsed by federal regulatory authorities. Because of substantial losses in the industry and the subsequent danger these failures present to the FSLIC's deposit insurance fund, the FHLB and FSLIC have recently been much more aggressive, pushing state regulators, including and in particular the California Department of Savings and Loan, into the background. Among other things, the supervisory staff of the FHLB of San Francisco has increased tremendously in the past three years. By comparison with the FHLB, the Department's regulatory capabilities are simply not as strong. Further, there is a general decline in the dual system of savings and loan regulation, with the federal regulators denying California applicants deposit insurance, ostensibly because the Department's inability to adequately supervise weakening savings and loan puts the FSLIC insurance fund at greater risk.

7. The Need for a Long-Term Departmental Plan

Throughout the Commission's analysis and consideration of the data, issues, and problematic points discussed above, it became clear that the Department might benefit substantially from taking a careful long-term view of the savings and loan industry, its mission, and its funding and staffing. The savings and loan industry is in the midst of difficult times, and is experiencing far greater difficulty than the banking industry.

The Department is faced with serious funding limitations, an increasing number of association failures, and a declining number of total examinations per year. In order to address these ongoing problems, the Commission recommends that the Department develop two separate strategic plans similar to that recently completed by the State Banking Department, one based upon existing budget constraints and one which contemplates additional resources.

Two plans are necessary because of continuing pressures on the Governor's budget. These pressures require any state agency to plan for operations using its existing budget and plan for the availability of additional resources, should they become available. The Commission does not suggest a third option, planning for a decrease in resources, because it is our opinion that the Department is currently operating at a level below the minimum it needs to perform its duties adequately.

The Commission suggests utilizing the same type of organizational perspective developed by the Banking Department because it is designed well and allows for flexibility in creating alternative strategies:

- PLANNING ASSUMPTIONS
  - Industry Changes
  - Industry Performance
  - California Economy
  - Department Resources
- SUPERVISION OBJECTIVE
- HUMAN RESOURCE OBJECTIVE
  - Hiring Strategy
  - Compensation Strategy
  - Promotion Strategy
- INFRASTRUCTURE OBJECTIVE
- INFORMATION OBJECTIVE

We have included some recommended strategies to be considered within each overall objective. With the Department's expertise, many more will become necessary as a result of the assessment necessary to create a long-term plan. We discuss our recommendations in detail below.

RECOMMENDATIONS TO THE DEPARTMENT OF SAVINGS AND LOAN*

The Department, based upon our review, has a more difficult task than the Department of Banking. In spite of what are obvious challenges, the Department has not taken creative or decisive steps to deal with the problems which confront it. The following recommendations will be of use to the Department in analyzing its current situation and in creating its long-range plan for the future of savings and loan regulation in California:

1. Strategic Planning

RECOMMENDATION 13 - New Departmental Revenues.

The Department requires more funding than it presently receives in order to effectively carry out its mission. The Department should seek additional alternative sources of funding. **The Legislature and the Department should consider a number of options for augmenting the Department's funding. The Legislature could mandate larger assessments against the Department's licensees. Or it could use the Department of Corporations as a model and channel Department assessments through the General Fund. This budgeting mechanism, if implemented, would add flexibility to the Department's budget and permit the Legislature to fund the Department according to regulatory needs, rather than the amount of assessments available to it.**

Alternatively, the possibility of securing offsets against the franchise tax for assessments against California-chartered associations, and thereby shifting costs to the General Fund, should be explored. Other states have permitted a franchise tax offset for assessments paid to the regulator, making the assessments more acceptable to the savings and loan industry.

RECOMMENDATION 14 - Strategic Plan Within Existing Resources.

The Strategic Plan '88 developed by the Banking Department provides a good model for the Department of Savings and Loan, acting within the scope of its current resource levels. Should there be no change in the Department's funding levels, there should still be a comprehensive reconsideration of departmental priorities, acknowledging the regulatory requirements of an industry in upheaval. The Commission will not suggest an alternative plan for a reduction in departmental resources, as the current resource levels are below the minimum required for

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* NOTE: Recommendations 1 - 12 deal with the State Banking Department, while Recommendations 13 - 20 are addressed to the Department of Savings and Loan.

the Department to adequately meet its responsibilities. In light of this the Department should, in this strategic plan, reduce the scope of its current goals and objectives to meet current funding levels.

RECOMMENDATION 15 - Strategic Plan With Additional Resources.

In this second strategic plan, the Department should evaluate, utilizing current and projected workload information based upon the most effective regulation, as opposed to the current situation, where the Department is staffed at the minimum necessary to carry out the letter of the law. **The present situation in the industry will not allow the Department to be satisfied with meeting the minimal regulatory standards, and the mission of the Department, part of which is to assure continued financial growth of savings and Loan associations, will not tolerate it. The Department must seek additional funds in order to be proactive -- to meet the demands of the changing market -- instead of following its current reactive course.**

2. Supervision Objective

RECOMMENDATION 16 - Fraud.

The recent congressional report cited elsewhere in this report states that fraud and other forms of misconduct were responsible for at least 80% of savings and loan insolvencies between January 1984 and June 1987. Savings and Loan Commissioner Crawford participated in these congressional hearings and is aware of their findings. **Like the State Banking Department, the Department of Savings and Loan should review the findings of this report in consultation with the Legislature, and working together, they should implement steps for improving the Department's ability to detect and respond to fraud, including establishing a fraud unit as recommended under Recommendation 19. In addition, the Legislature and the Department should jointly review the law and determine whether there is adequate legislation to deal with insider transactions, and whether the Department has enough support from criminal law enforcement agencies. The Department should evaluate whether a public Attorney General approach, where citizens who bring fraudulent activity to the attention of enforcement agencies are entitled to a percentage of any proceeds, would be an effective deterrent in this area.**

In addition, some members of the Commission felt strongly that jail sentences should be mandatory when officers of an institution are convicted of fraud or misconduct, and that upon their conviction, officers should also lose their pension and profit-sharing rights.

RECOMMENDATION 17 - More Frequent Examinations

The Department apparently plans to examine institutions under its supervision no more than roughly once a year, with some added supervision for troubled institutions. Given the extreme turmoil in the industry, we believe that this is an insufficient amount of supervision. **The Department should examine every one of its licensees at least once a year. Troubled institutions should be examined at least every six months.** Increasing the frequency of examinations should help the Department to detect problems earlier, as well as acting as a deterrent to those who might otherwise attempt fraud or other misconduct.

RECOMMENDATION 18 - Depoliticize Savings and Loan Commissioner.

The Savings and Loan Commissioner should be protected from political influence. In our interview with one Commissioner, he advised of instances where attorneys close to the Governor acted as representatives for state-chartered associations. Even without any overt pressures, the nature of the relationship between the attorney and the Governor made the Commissioner feel vulnerable in carrying out his duties. **That sense of vulnerability should be reduced by amending current law to permit the Savings and Loan Commissioner, once appointed, to be removed by a governor only for serious cause.** This would mirror the appointment process for the Comptroller of the Currency at the federal level.

RECOMMENDATION 19 - Joint Examination and Reports With FHLB.

Presently, the Department does not have the resources to examine associations with the depth of scrutiny now provided by the Federal Home Loan Bank of San Francisco. Rather than carry out a parallel, though coordinated examination, the Department should carry out joint examinations with the FHLB of San Francisco, focusing on those areas where the California charter provides for powers beyond those available to a federal Association. Thus Department of savings and Loan examiners could focus on: (1) service corporation activities, including compliance with by the Association with the service corporation agreement that is required for every service corporation of a California-Chartered Association; and (2) the broader powers available to associations in terms of consumer and commercial lending. **The Department should also focus on key problem areas within associations or focus upon problem associations through joint examinations.**

3. Human Resources Objective

RECOMMENDATION 20 - Personnel Reforms.

The same recommendations made earlier regarding the hiring, compensation, training, and career counseling of the Department of Banking are equally applicable to the Department of Savings and Loan.

4. Infrastructure Objective

RECOMMENDATION 21 - Fraud Unit.

The recommendations identified earlier regarding the establishment of a fraud unit in the Department of Banking are equally applicable to the Department of Savings and Loan.

Despite the widespread nature of the fraud problem in the savings and loan industry, the Department does not have a fraud unit. **The Department and the Legislature should work together to establish a special fraud unit, staffed by several full-time investigators, preferably with peace officer status. This unit should also be staffed with its own secretarial support services and legal counsel. It is possible that existing Department resources could be assigned on a part-time basis to accommodate these needs; if not, the Legislature should provide the Department with supplemental resources earmarked for this purpose. It is essential, to reduce the future cost of institutional failures to California taxpayers, for the Department to have a much better fraud detection and prevention capability than it has today.**

5. Information Objective

RECOMMENDATION 22 - Additional Information.

In addition to the recommendations previously set forth for the Department of Banking, particularly the recommendation concerning forms and questionnaires on management policies and procedures, the Department of Savings and Loan should consider whether it has enough information on potential problem areas, including service corporations. **We recommend that regulators get monthly computer data from institutions so that dangers can be spotted more quickly, and that automation be more thoroughly employed throughout the Department's operations.**

COMBINING THE BANKING AND SAVINGS AND LOAN REGULATORY FUNCTIONS

The notion of combining the banking and savings and loan regulatory functions was proposed in California as early as 1976, by then Business, Transportation and Housing Secretary Donald Burns. The "Department of Financial Institutions," as it was to have been called, would have also overseen credit unions and other lending-trust firms. Four years before deregulation made this a top consideration in many states and the federal government, combining financial regulatory agencies was vehemently opposed by industry trade associations.

One of the prime reasons for the proposal, Burns said at the time, is that "sometimes, with regulatory agencies, they tend to be co-opted by the industries they were designed to regulate. This has happened in many states and it may have happened here in California".[38] In addition, he indicated that, because of competition, banks, savings and loans, and other financial institutions are "under tremendous pressure to become alike," and government has to "be ready for the future".[39] The future arrived in 1980, in the form of deregulation. Since that time, there have been efforts, many successful, at the state level to consolidate the functions of banking and savings and loan regulators into one state agency.

However, in one of the most comprehensive studies undertaken on the subject of modernizing financial regulatory institutions, the State of New York's DeWind Commission recommended in a 1984 report that financial institutions be regulated by function -- that the separate activities of multi-service firms should be supervised and regulated by the appropriate state authority depending on the nature of the activity, rather than by the charter the institution holds. "Thus," they concluded, "the Commission firmly believes that the insurance agency activities in which banks may be authorized to engage should be supervised by the Insurance Department," and so on.

At the federal level, Vice President George Bush chaired the "Task Group on Regulation of Financial Services," which recommended consolidation by eliminating the FDIC's role in examining and regulating state non-member banks. The Task Group recommended creating a new "Federal Banking Agency" within the Treasury Department, incorporating the Office of the Comptroller of the Currency. These recommendations have not been implemented.

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[38] Sacramento Bee, February 8, 1976, p. A1.

[39] Ibid.

In recent months, there has been considerable public debate and discussion regarding the consolidation of the two federal insurance funds, the FDIC and the FSLIC, primarily because of the weakness of the savings and loan fund, but also because of the blurring of institutional lines between banks and savings and loan. This debate has again raised the question of consolidation of the California state financial regulators.

The Commission believes that the question of consolidating the State Banking Department and the Department of Savings and Loan should remain a topic for further consideration and study. However, we believe it would be premature at this stage to recommend consolidation because there remain substantial differences in the way the two Departments use and train examiners and in the regulatory structure governing each Department's functions and operations. In addition, the administrative cost savings potential may not presently justify the consolidation.

Nevertheless, **the entire area of regulation of financial institutions should have a higher profile in state government. The Governor and his administration must make this a high priority and assure that energy and resources are focused on the very serious problems outlined in this report.** While merging the Departments might not make sense at this point, it is vital that their regulatory needs be recognized and met if the state is to effectively respond to the very serious problems present in California's financial industry today.

NOTES ON METHODOLOGY

In completing this report, the Commission utilized a number of sources, conducting hearings, interviewing observers of the Departments of State Banking and Savings and Loan, and making written inquiries of the Departments.

Witnesses attending meetings of the Subcommittee on Financial Institutions and offering their insights on California's financial regulatory process included former Secretaries of Business, Transportation and Housing Don Burns, Richard Silberman, and Lynn Schenk, as well as Senate Majority Leader Barry Keene.

Pro bono consultants to the Commission John B. McNeece III and A. Vincent Siciliano, along with Commission staff, conducted interviews with the following individuals: Howard Gould, Superintendent of Banks; William J. Crawford, Savings and Loan Commissioner; Dean Cannon, President, California League of Savings and Loans; Gus Bonta, Executive Director, California Bankers' Association; and Michael Patriarca, Director, Agency Group, Federal Home Loan Bank of San Francisco.

The Commission is grateful for the cooperation of the State Banking Department and the Department of Savings and Loan. Responses to the Commission's extensive written inquiries were supplied by Steven Suchil, Counsel and Legislative Coordinator of the State Banking Department, and Shirley Thayer, Senior Staff Counsel to the Department of Savings and Loan.

Finally, the Commission gained valuable insights on personnel issues within the Departments from the September 1987 report of the Auditor General entitled "A Review of Examiner, Auditor, and Appraiser Attrition in the State Banking Department, The Department of Savings and Loan, the Department of Corporations, and the Department of Real Estate."