FEATURE ARTICLE

Partners in Crime: California's Role in the $335 Billion Savings and Loan Heist

*by Carl K. Oshiro**

Introduction

Since 1985, over 700 savings and loan institutions have failed in the United States. An additional 300 to 800 S&Ls are expected to fail in the years ahead. Recently, the General Accounting Office revised its estimate of the cost of the S&L disaster to $335 billion.[1] This is more than $1,000 for each man, woman, and child in the country.

The California legislature, California savings and loan industry, and state regulators bear a major responsibility for this massive calamity. To attract more state-chartered S&Ls, they dismantled state laws which regulated the conduct of these institutions and opened the way for widespread fraud and mismanagement. This article describes how the State of California recklessly gambled on deregulation, how that policy failed, and why the actions of state officials are now costing federal taxpayers billions of dollars.

The Dual System

Since the 1930s, the savings and loan industry has been subject to a dual system of regulation. Under this system, S&Ls may be chartered as either a state or federal institution. In California, state-chartered S&Ls are authorized by the Savings Association Law[2] and are regulated by the California Department of Savings and Loan (DSL). Virtually the entire budget for the Department is collected through an annual assessment levied on state-chartered institutions.[3]

Until 1989, federally-chartered S&Ls were regulated by the Federal Home Loan Bank Board (FHLBB). Federally-chartered institutions were also members of the Federal Savings and Loan Insurance Corporation (FSLIC), which guaranteed consumer deposits. State-chartered S&Ls could also join the FSLIC. Under California law, all state-chartered S&Ls were required to be insured by the FSLIC before they could accept deposits.[4]

**The author is the Northern California Supervising Attorney of the Center for Public Interest Law.*

Proponents of the dual system maintained that it allowed for experimentation and innovation in the S&L industry. However, the dual system also enabled the industry to weaken government supervision by encouraging competition among regulators. The S&L crisis took root in California precisely because of such competition. Concerned about the large-scale conversion of state S&Ls to federal charters in the early 1980s, state officials sought to entice them back by repealing statutory restrictions and weakening the state's ability to supervise these institutions.

The Race to the Bottom

Both state and federal S&Ls came under extreme pressure in the late 1970s and early 1980s. Deregulation of interest rates paid on consumer deposits caused the cost of funds to increase sharply for S&Ls. Instead of paying the historic passbook rates of 3-5%, they were paying 10-12% to stay competitive with money market mutual funds.[5] At the same time, S&L portfolios consisted of thirty-year mortgages, fixed at rates of 6-10%. The result was that the S&Ls were awash in red ink.[6]

S&Ls sought several ways out of this dilemma. First, they attempted to reduce the amount of fixed-rate mortgages in their portfolios by enforcing "due on sale" clauses. Enforcement of these clauses in loan agreements prevented buyers from assuming the low, fixed-rate mortgages from sellers. Second, S&Ls requested authority to offer adjustable rate mortgages (ARMs) to reduce the risk of higher interest rates. Unlike fixed-rate mortgages, the rates for ARMs would rise and fall with the level of interest rates paid by financial institutions. Third, S&Ls sought authority to diversify their investments. Instead of investing exclusively in home mortgages, S&Ls wanted permission to invest in a wide range of ventures, some of which would pay high returns.

S&Ls met with little success at the state level. In 1978, the California Supreme Court held in *Wellenkamp v. Bank of America*[7] that due on sale clauses were "unconscionable," and therefore could not be enforced. In 1980, Governor Brown vetoed SB 1937 (Foran), which would have given state-chartered institutions the power to offer adjustable rate mortgages. Through 1982, the Financial Code set strict limits on the types and amount of investments state-chartered S&Ls could make.

The S&L industry found the federal government to be more receptive. In 1982, the U. S. Supreme Court held that federally-chartered institutions were exempt from the *Wellenkamp* decision.[8] In 1981, the FHLBB authorized all federally-chartered S&Ls to offer adjustable rate mortgages.[9] The Garn-St. Germain Depository Institutions Act of 1982 expanded the powers available to federal thrifts.[10] Under the Act, federal S&Ls were allowed to make commercial loans and restrictions on real estate investments were eliminated.

The advantages of a federal charter were immediately obvious to most S&Ls in California. Many converted from state to federal charters, with devastating results on the DSL. During the 1981-82 fiscal year, 50 of the 93 institutions regulated by the Department either converted to or merged with federal institutions, resulting in the loss of 68% of the assessment funds used to run the Department.[11]

The flight of state-chartered institutions was so serious that the Department's survival as an independent agency was threatened. In 1982, the Legislative Analyst recommended that the Department of Savings and Loan be merged with Department of Banking.[12] While DSL was able to fend off such a merger, its staffing continued to decrease. According to former Savings and Loan Commissioner William Crawford, "In 1983 the Department hit bottom with 42 employees on duty [down from 175 employees in 1977] and most of its reporting and monitoring system dismantled."[13]

AB 3539. In 1982, AB 3539 (Nolan) was introduced to stop the conversion of state institutions and woo them back from federal charters by eliminating many of the restrictions on the types and amounts of investments for state-chartered S&Ls. Most significantly, AB 3539 allowed S&Ls to invest as much as 100% of their assets in service corporation subsidiaries, which, in turn, could invest in virtually any activity. The bill also allowed state-chartered S&Ls to directly invest in real estate projects.

Its author, Assemblymember Pat Nolan (R-Glendale), cited three reasons for the legislation. First, he claimed it would "eliminate artificial and archaic limitations on the authorized investment portfolio of state-chartered S&L associations and provide them with the authority to fully utilize their statutory investment and loan powers." Second, he contended that "AB 3539 does not take S&Ls away from their primary obligation to housing finance. It will guarantee that S&Ls will be able to stay in the housing market by providing them with the tools to stay afloat during these turbulent times." Third, by benefiting only state-chartered S&Ls, AB 3539 "may persuade those associations which are considering converting to federal charters to retain their state-chartered status."[14]

AB 3539 was sponsored by the California Savings and Loan League (now called the California League of Savings Institutions) and supported by five S&Ls, including Mt. Whitney Savings & Loan (Exeter), Seaside Savings & Loan (Mission Viejo), State Savings & Loan (Stockton), Lincoln Savings & Loan (Monterey Park), and Sun Savings & Loan (San Diego).[15] The League claimed that the existing statutory ceilings on investments were outmoded and that S&Ls "needed versatility" in their investment powers in order to survive.[16]

A strong supporter of AB 3539 was the outgoing California Savings and Loan Commissioner Linda Tsao Yang. She advised the Governor that the following benefits would result from the legislation:

-The elimination of restrictions on the authority of savings and loans to make the types of loans and investments specified by this bill would facilitate the use of business judgment by the management of state-licensed savings and loan associations.

-Savings and loan associations need to have the flexibility to structure investment portfolios which in the judgment of their investment advisors will bring the highest rate of return within the confines of prudent investment practices. The removal of arbitrary percentage of assets limitations may allow savings and loan associations to obtain a greater return on their investments, thereby making more funds available for mortgage lending.

-Elimination of the percentage of assets limitation on real estate owned by a savings and loan association may prompt an increase of residential construction financed and developed by savings and loan associations, which could prove to be highly profitable for the association while creating jobs and increasing the housing stock in California.

-It would be in the public interest to maintain the state-chartered system as an attractive environment for savings and loans within which to operate, allowing the state to play a meaningful role in the supervision of this important industry.[17]

There was only token opposition to the measure. Initially, AB 3539 was opposed by the California Bankers Association, which objected to the elimination of the 20% maximum limit on consumer loans and commercial paper because it would place commercial banks at a "competitive disadvantage."[18] Bank of America, Crocker National Bank, and Wells Fargo Bank also opposed the lifting of the investment restriction on service corporations, fearing that S&Ls could use such corporations to compete for consumer and commercial lending.[19] However, CBA and the individual banks withdrew their opposition before the bill reached the Governor's desk.

With strong support from the S&L industry, vigorous endorsement by state regulators, and only mild opposition from banks, AB 3539 sailed through the Senate by a vote of 22-1, through the Assembly 67-1, and was signed by the Governor.[20]

AB 2574. Following the enactment of AB 3539, the state legislature passed AB 2574 (Sebastiani). The bill "cleaned up" AB 3539 and eliminated the requirement that the Department of Savings and Loan conduct biennial solvency examinations of state-chartered savings and loan associations.

AB 2574 was sponsored by the California Savings and Loan League and supported by DSL and the Department of Finance. The only cautionary word came from the Assembly Office of Research, which stated: "According to the Senate Banking and Commerce Committee, the Senate amendments significantly alter the restrictions on the investments savings and loan associations can make. These, combined with the relaxed examination requirement, might encourage savings and loan associations to make investments that could, in times of economic hardship, threaten the solvency of the associations."[21]

The bill passed 37-0 in the Senate and 69-0 in the Assembly, and was signed by the Governor.[22]

AB 1434 (Bane). In 1983, the California legislature recodified the entire Savings Association Law, incorporating additional incentives for state-chartered institutions. Among other things, AB 1434:

-repealed the requirement that at least two-thirds of the board of directors of a state-chartered association be California residents;

-allowed an association, with the consent of the Savings and Loan Commissioner, to conduct business outside of California;

-eliminated restrictions on the types of loans state-chartered S&Ls could make on nonresidential real estate;

-allowed state-chartered S&Ls to borrow funds from any source without limitation and use any of their own assets to guarantee their debts; and

-allowed state S&Ls to organize as savings banks.[23]

According to the analysis prepared by the Assembly Finance and Insurance Committee, the purpose of AB 1434 was to "allow savings associations to effectively compete with federal associations" and "permit management greater use of business judgment."[24] The analysis described AB 1434 as providing "savings associations with an exceedingly flexible framework within which to operate and should certainly accomplish the objectives of the industry and regulators." Despite opposition from banks (which opposed the savings bank provision), AB 1434 passed 38-0 in the Senate, 77-0 in the Assembly, and was signed by the Governor.[25]

Throughout this period, the focus of state and federal policymakers was on giving S&L managers greater leeway in running their institutions. Policymakers spoke of "flexibility," "deregulation," "business judgment," "entrepreneurship," and "higher earnings." No one spoke of "risk," "losses," "abuse," or "fraud," or what these might do to the public at large.

Nor was there much discussion about the need for more auditors, appraisers, and examiners to supervise S&Ls' use of these expanded powers. In 1983, the Department of Savings and Loan employed a total of 42 people, far less than was needed to oversee the rapid expansion in the California S&L industry.

State Applications Soar. The inducements worked. In 1983 and 1984, DSL received a total of 210 new applications for state-chartered institutions in California.[26] The new S&L Commissioner, Lawrence Taggart, welcomed these applications. In testimony before the House Government Operations Committee in 1989, Taggart stated that he felt that it was his "job...to encourage the Nolan Bill [AB 3539]. I even went out and encouraged people to commit to new institutions...."[27]

Many of newly chartered institutions used their expanded powers to invest in high-risk projects. A review of the lending activities of 29 failed California S&Ls by William Black, General Counsel of the Federal Home Loan Bank of San Francisco, shows that from 1982 to 1986 the percentage of home loans made by these institutions declined steadily, and the percentage of direct investment and acquisition, development, and land (ADL) loans increased dramatically.[28]

Mr. Black's review also shows that by 1985, many of these riskier loans were in deep trouble. From 1982 to 1984, slow loans[29] and real estate owned by the 29 S&Ls were stable at less than 5% of their assets. Beginning in 1985, these rates shot up as borrowers defaulted on their payments and property was foreclosed. By 1986, slow loans and real estate owned represented nearly 25% of the assets of these institutions.[30]

Despite overall increases in staff, the Department of Savings and Loan did not have the resources to effectively regulate the large number of S&Ls wielding extensive new powers. In 1989, James Cirona, President of the Federal Home Loan Bank of San Francisco, testified that even with increased staffing, the ratio of professional staff per billion dollars in assets held by state-chartered S&Ls fell during this period.[31]

"I am Pitching for You." By 1983, federal regulators were growing concerned about the expanded powers granted to California S&Ls. To curb the growth of these institutions, the Federal Home Loan Bank Board imposed a moratorium on federal insurance for California thrifts and began the process of adopting rules which set limits on investment authority and raised capital and net worth requirements for new S&Ls seeking federal deposit insurance.[32] In late 1983, the FHLBB and FDIC proposed new rules to limit federal insurance for brokered deposits.[33]

In both instances, Commissioner Taggart rallied to the defense of his state-chartered thrifts. He criticized the Board for trying to preempt liberal California laws and said that the Board was "attacking the wrong thing" with its rule on brokered deposits.[34] At a gathering of nearly 100 angry organizers of new S&Ls in Los Angeles, Commissioner Taggart said, "I am pitching for you."[35]

The California League of Savings Institutions (formerly the California Savings and Loan League) was equally opposed to efforts to curb the expanded powers. In 1983, Ray Martin, the League's newly elected chair, identified two major priorities for the year: helping thrifts to develop the new powers given them in the Garn-St. Germain Act of 1982, and fighting any new attempts to cut back by reregulation on the expansive powers afforded by the state. "We have to be alert and concerned about any attempts in the future to reregulate the industry," Mr. Martin warned.[36]

The Crash

Even as Commissioner Taggart and the League were defending the California S&Ls, many were in trouble. From January 1, 1983 (the effective date of AB 3539) to September 1, 1990, S&L regulators took control of 77 insolvent S&Ls in California, all but seven of which were state-chartered institutions.[37] Among the thrifts that failed during this period were the five S&Ls that actively supported the Nolan Bill.

Mt. Whitney Savings and Loan. Mt. Whitney Savings and Loan (Exeter) was placed into FSLIC conservatorship in 1986 and finally liquidated in 1988. According to the *Los Angeles Times*, "Mt. Whitney's financial difficulties began in 1982, when its previous management began soliciting high-cost jumbo certificates of deposit that were invested in lower paying government securities and questionable loans."[38] Mt. Whitney's problems were also attributed to "losses on poorly underwritten and speculative construction loans."[39]

In 1987, the Federal Home Loan Bank of San Francisco reported to Congress that Mt. Whitney's insolvency would result in a loss to the FSLIC of $35 million.[40] It also reported that the FSLIC had filed complaints against fifteen insiders, seeking recovery of $17 million.[41]

Seaside Savings and Sun Savings & Loan. Seaside Savings merged into Sun Savings & Loan in late 1982. In 1986, Sun was closed by the FSLIC and liquidated. In testimony before a subcommittee of the House Government Operations Committee, David Lundin, outside fee counsel to the Bank Board and FSLIC, described the problems at Sun as follows:

> First, Sun was a new, publicly traded savings and loan association in the newly-deregulated marketplace of the 1980s. Much of Sun's management can best be described as aggressively incompetent. They did, however, respond to market pressures to stimulate rapid and profitable growth—at least in the short run.
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> Growth in the thrift industry results from an ability to generate deposits and make profitable loans. Traditionally in the thrift industry deposits were nurtured over a period of time from a geographically local deposit base and were prudently lent within that same geographic market place, a market place known to the lender.
>
> By contrast, Sun generated the majority of its deposits as brokered funds in short-term jumbo C.D.s, paying broker's fees for the initial deposits and premium rates for the privilege of holding these volatile, short-term funds.
>
> Sun then had to place these funds at work. As a new and small association, it neither had a significant share of the local lending market, not did it have the resources to single-handedly underwrite a large volume of local loans to profitably occupy its brokered deposit base.
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> Sun's need to make loans created a demand for two products: participation interests primarily underwritten and serviced by other lenders and loans privately brokered to Sun.
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> While there is nothing inherently wrong with loan participations, a participating lender is often dependent upon the lead and servicing lender for detailed underwriting, experience with the borrower, local appraisers and knowledge of the local geographic market. If this dependence is misplaced for any reason, the results are obvious.
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> Many of Sun's participations were good, performing loans. Many were not. Many of Sun's participations were with other ultimately troubled and now-closed associations, including Eureka Savings and Loan, State Savings and Loan Association of Utah, and Hawaii and First Savings and Loan Association of Orland Park, Illinois.
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> Eureka, now closed by regulators, was operated by the Kidwell brothers. Its failure has been attributed in part to losses arising from loans to Las Vegas casinos and to William Oldenberg.
>
> State Savings and Loan was owned and controlled by Mr. Oldenberg. That failure has been attributed in part by [sic] self-dealing by Mr. Oldenberg, including the sale of parcel of Bay Area property which he had personally acquired for $800,000 which was then sold to State for $55 million.

First of Orland Park was closed by regulators in late 1986. Several among its controlling group have been indicted by a Federal Grand Jury in the Northern District of Illinois.

Sun also relied upon loan brokers to provide borrowers of the brokered deposits....[Some] brokers extract large up-front fees for loans promised and never made. Some facilitate their clients' frauds by not disclosing adverse credit information or even prior criminal convictions for bank fraud. Others are more overt and may simply bribe bank officers as needed to obtain loans and related brokerage fees.

A highly disproportionate share of the loans brokered to Sun were non-performing loans and resulted in losses to the Association and ultimately to the FSLIC. Among these loans were ones to Morris Shenker and the Dunes Hotel and Casino, where Sun's President and CEO claims to have won much of his $200,000 which was deposited to the secret account.

These participations and brokered loans were a major contributing cause to Sun's failure. It is currently estimated that this failure alone will cost the FSLIC approximately $114 million dollars.[42]

In 1989, Sun's President Daniel Dierdorff was convicted of two felony counts of misuse of the institution's funds and sentenced to eight years in prison.[43]

State Savings and Loan (American Savings and Loan). In 1983, State Savings and Loan (Stockton) merged with First Charter Financial Corporation to form American Savings and Loan, the largest S&L in the country.[44] Under the direction of Charles Knapp, American Savings became one of most aggressive institutions in the use of its expanded powers. The *Los Angeles Times* reported: "Fueled by high-rate deposits from Wall Street 'money brokers,' Knapp financed real estate ventures and securities purchases. In 1984, he was ousted by regulators after the Securities and Exchange Commission forced FCA [American's parent] to restate its earnings to show a huge loss, which triggered a $7-billion run on deposits."[45]

Knapp's successor, William Popejoy, was unable to turn American Savings around and, in 1988, it was sold to Robert Bass. The deal included $1.7 billion in federal subsidies to entice the Texas billionaire to take over the insolvent institution.

Lincoln Savings and Loan. Lincoln Savings & Loan (Monterey Park) was acquired in 1984 by American Continental Corporation. Lincoln was placed in FSLIC receivership in August 1989. Under the direction of Charles Keating, Jr., Lincoln Savings invested heavily in junk bonds and risky real estate projects. The collapse of Lincoln Savings—the details of which are currently unfolding through civil litigation, criminal prosecutions, and state and federal regulatory enforcement actions—is expected to be one of the largest S&L failures in U.S. history, costing taxpayers as much as $2 billion.[46]

On September 19, 1990, Mr. Keating was indicted on 42 counts of state securities fraud arising from the sale of $200 million in uninsured bonds to Lincoln customers.[47] The bonds were rendered virtually worthless when American Continental declared bankruptcy and Lincoln Savings was seized by federal regulators.

The Best Way to Rob a Bank is to Own a Bank. The new powers granted to S&Ls and lack of effective supervision by state regulators opened the way for fraud and abuse by S&L managers. In 1987, the new Savings and Loan Commissioner, William J. Crawford, reported to the House Subcommittee on Commerce, Consumer, and Monetary Affairs that over the previous two and one-half years, he had been forced to close thirty state-chartered, federally insured S&Ls; and that in almost every closure, insider misconduct played a significant or even a determining role.[48] In testimony before the subcommittee, Commissioner Crawford stated:

> The controls, historically, were set out to protect the cash and securities in a financial institution. They always wanted to protect against the officers stealing the cash, and the tellers stealing the cash; somebody converting securities, bearer securities to their personal use. We build thick vaults; we have cameras; we have time clocks on the vaults; we have dual control—all these controls to protect against somebody stealing the cash.
>
> Well, you can steal far more money, and take it out the back door. The best way to rob a bank is to own one. If you have 100 percent control, you can make yourself the chairman of the audit committee, the chairman of all committees....The system of internal control doesn't work. We've gone upscale where we have got temptation, opportunity, and greed; we are handling much larger sums of money.[49]

In 1989, the U.S. General Accounting Office reported that in investigating 26 failed thrifts (eight of which were in California), all had changed from traditional to high-risk activity.[50] GAO also found evidence of insider abuse and fraud at each and every one of these failed institutions.[51] The GAO found that insider abuse flourished because of:

-Inadequate supervision by directors of the thrift and dominance by one or more individuals.

-Breach of fiduciary duty to the thrift by officers and directors. GAO found that 77% of the S&Ls examined violated conflict of interest regulations or engaged in related unsafe practices.

-Inadequate underwriting or administration of loans.

-Noncompliance with loan terms.

-Excessive compensation and expenditures.

-Extensive and imprudent participation in acquisition, development, and construction transactions, often with related parties. GAO cited one California thrift that lent $40 million to one borrower principally to build condominiums and a shopping center. No feasibility studies were done. Examiners stated that studies would have shown that the area was already heavily overbuilt before the loans were ever made. The thrift was expected to lose over $10 million on the project.

-Loans to borrowers exceeding legal limits. Examiners found that 88% of the failed thrifts violated a federal regulation limiting the amount of money thrifts can lend to a single borrower.

-Sloppy and intentionally deceptive recordkeeping.

GAO found that because of the dual regulatory system, federal officials were uncertain about their authority to curb the use of expanded powers granted to state-chartered S&Ls. The GAO report states:

> Bank Board officials also told us that before 1985 they viewed their authority to issue regulations to restrain state-chartered thrifts from engaging in high-risk activities as "questionable." The officials said that Bank Board officials at that time were hesitant to act in certain instances, especially where state law gave thrifts specific powers which federal laws did not address.
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> Twenty of the 26 failed institutions reviewed were state-chartered. While the Bank Board limited federally chartered thrifts from making certain "direct investments" (such as equity

securities, real estate, service corporations, and operating subsidiaries, etc.), state-chartered thrifts often were authorized to make such direct investments under state law. Moreover, FSLIC did not have regulations which placed limitations on the type and amount of direct investments insured thrifts could make.[52]

As federal officials questioned their legal authority over state-chartered S&Ls, the unsupervised use of the expanded powers led to even more losses for the FSLIC. In February 1989, the Office of Management and Budget estimated that the cost of resolving the S&L crisis would cost the federal government $158 billion; in September 1990, that figure was revised to an astounding *$335 billion*.[53]

FIRREA

By 1989, members of Congress were aware that the dual regulatory system for thrifts had contributed to the massive losses to the FSLIC. To stem these losses, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).[54] The Act represents a complete rejection of the dual system of thrift regulation. Recently, Senator Don Riegle, Jr., Chair of the Senate Banking Committee, described one of FIRREA's chief objectives as follows:

> [The Act] also placed important new restrictions on State powers. Prior to FIRREA's enactment, State law alone provided the only limitations on the powers of State-chartered thrifts....In several states, those limitations were not very substantial. The States of Texas and California, in particular, removed virtually all restrictions on the investment activities of State-chartered thrifts within their States, all of them nevertheless connected to the Federal deposit insurance system. This permitted California and Texas thrifts to raise deposits and invest them in virtually anything, knowing that the Federal deposit insurance system would pick up any loss that might result. Many thrifts exploited this opportunity to the hilt, raising brokered deposits and investing them in such things as racetracks, windmill farms, junk bonds, raw land, and other things of that sort. The consequences of such abuses for the Federal deposit insurance system were catastrophic....In 1977, 54 percent of all of the losses in the national system went to pay for losses incurred by State-chartered thrifts in just two states, the States of California and Texas alone. And that figure grew in 1988. Fully 70 percent of all of the payouts from the insurance fund went to cover losses by State-chartered thrifts in those same two States, Texas and California.

FIRREA put a stop to those abuses. The statute generally restricted State thrifts to activities permissible for Federal thrifts, creating exceptions only for State thrifts that fully satisfy all applicable capital standards and in turn can meet a second test, namely to convince the FDIC that the activity in question poses no significant risk of loss to the deposit insurance fund.[55]

FIRREA significantly expands the role of federal regulators in overseeing the S&L industry. The FHLBB, which was responsible for chartering federal S&Ls and overseeing the FSLIC, was abolished. FIRREA created a new agency, the Office of Thrift Supervision (OTS), to be the primary regulator of both federally-chartered and state-chartered S&Ls.[56] To replace the FSLIC, the Act established a Savings Association Insurance Fund (SAIF), administered by the Federal Deposit Insurance Corporation (FDIC).[57] The FDIC is granted substantial new powers over both state and federal institutions to protect the safety of the SAIF.[58]

The Act sets stiffer capital requirements for S&Ls.[59] An S&L that fails to meet these requirements must submit a business plan to OTS addressing (1) the need for increased capital, (2) how such capital is to be acquired, and (3) the types of activities in which the S&L plans to engage. The plan must be approved by OTS. After January 1, 1991, OTS is required to restrict the asset growth of any S&L that fails to meet the capital standards.[60]

To address the abuses prevalent in the S&L industry, FIRREA also:

-requires that the loan-to-one-borrower restrictions for national banks apply to all S&Ls;[61]

-prohibits S&Ls from investing in junk bonds and requires that S&Ls remove them from portfolios by July 1, 1994;[62]

-prohibits S&Ls from directly investing in real estate and other ventures, and restricts investment in service corporations;[63]

-restricts nonresidential real estate loans to 400% of a S&L's capital;[64]

-restricts transactions between affiliated entities and prohibits below-market rate loans to S&L insiders;[65]

-prohibits the use of brokered deposits by S&Ls failing to meet the new capital requirements;[66]

-protects S&L employees who report violations to federal regulators;[67] and

-establishes new civil and criminal penalties for fraud and abuse.[68]

In addition, FIRREA establishes a stringent new test to ensure that S&Ls maintain a strong commitment to residential lending.[69] Institutions that fail to meet this test may be required to convert to commercial banks. Beginning July 1, 1991, at least 70% of a S&L's portfolio must consist of loans for the purchase, refinancing, construction, improvement, or repair of domestic residential housing and related investments. Effective immediately, S&Ls that fail this Qualified Thrift Lender (QTL) test may obtain advances from Federal Home Loan Banks only for the purpose of funding residential housing. Beginning in August 1990, S&Ls which are not QTLs will be be forced to limit their activities to those permissible to national banks and will no longer be eligible for any new advances from the Federal Home Loan Banks. Two years later, S&Ls which are not QTLs will be required to divest themselves of all investments, cease engaging in activities not permitted to national banks, and repay all outstanding advances owed to the Federal Home Loan Bank system.[70]

It is far too early to know whether these reforms will ultimately result in a healthy S&L industry. As of June 1990, the S&L industry was showing neither dramatic improvement nor precipitous decline. As a whole, the industry is still in poor condition. Of the 2,949 S&Ls operating in the United States at the end of 1988, over 400 were in government control. Of the S&Ls not in government control, about 20% are undercapitalized or insolvent, 33% are squeaking by, and less than half are healthy.[71]

Conclusion

The last time the savings and loan industry was in such serious distress was in the 1930s. In 1934, Congress enacted the National Housing Act to restore public confidence by creating the FSLIC to insure consumer deposits.[72] For deposit insurance to work, S&L regulators must be extremely vigilant to prevent, detect, and immediately halt those practices which pose a threat to an institution's solvency. Without such vigilance, S&L

managers will gamble with consumer deposits. Heads—they win; tails—the federal taxpayer loses.

In the 1980s, deposit insurance encouraged the California legislature and state regulators to gamble with consumer deposits. Fearing the loss of state-chartered institutions to the federal government, state officials bet that deregulation would win those institutions back to state "control". That gamble worked for awhile, but the staggering losses which ensued forced the federal government to assume control over both state and federally-chartered institutions.

The California legislature's servile compliance with the deregulation ambitions of the industry was not merely the consequence of Republican deregulation ideology. As noted above, the votes were nearly unanimous. The savings and loan industry gave prodigious sums in campaign contributions to California legislators while these measures were considered, and afterwards. Common Cause reports that, over the ten-year period of 1979-1989 during which the deregulation steps proceeded, the industry contributed $4,117,239 to elected state officials. This California total is over one-half the total amount in reported contributions to the entire United States Congress over the same period. Over one-quarter of the state total came from savings and loans subsequently rendered insolvent, including American Savings and Loan ($327,342), Columbia Savings and Loan ($240,460), Mercury Savings and Loan ($189,838), and Lincoln Savings and Loan ($165,251).

During this ten-year period, Assemblymember Tom Bane, who authored AB 1434, received $513,000 from the S&L industry—more than twice the sum received by California Senator Pete Wilson, the largest recipient of any member of Congress. Between 1981 and 1989, Assembly Speaker Willie Brown received $215,740 and Senate President pro Tempore David Roberti received $214,417 from the industry. In 1986-87, Governor George Deukmejian, who appointed Lawrence Taggart as Director of the Department of Savings and Loan in 1983 and signed all three deregulation bills, received $130,000 from Charles Keating, his family, Lincoln Savings and Loan, and associated entities.

The total industry contributions to California officials stood at $735,434 in 1979-80 when federal deregulation began. They shrunk to $480,979 in 1981-82 as savings and loan institutions left state charter for federal deregulation, and California elected officials became less important. Then the amounts increased to $651,563 as the three bills described above were enacted, and continued up to $1,194,660 in the 1985-86 period just before the crash.[73]

FIRREA marks the end of California's reckless policy of deregulation. Instead of expanding its control over the S&L industry, state officials ended up losing all meaningful control to the federal government.[74] Instead of strengthening the S&L industry, the California legislature assisted in its destruction. Instead of serving the California public, state officials betrayed their public trust and added billions of dollars to the burden paid by federal taxpayers.

FOOTNOTES

1. *Seidman Totals Costs of S&L Bailout; Election Year Congress Talks of New Taxes*, Wall St. J., Sept. 20, 1990, at A-2.
2. Financial Code § 5000 *et seq.*
3. Financial Code §§ 8030-38.
4. Financial Code § 5606.
5. U.S. League of Savings Institutions, *Savings Institutions Sourcebook* (1989) at 24.
6. In 1981, on a nationwide basis, the S&L industry suffered a $4.6 billion after-tax loss, for a negative 15.39% return on equity. *Id.* at 52, 55.
7. 21 Cal. 3d 943 (1978).
8. *Fidelity Federal Savings & Loan Ass'n v. De La Cuesta*, 458 U.S. 141 (1982).
9. FHLBB, Adjustable Mortgage Loan Instruments, 46 Fed. Reg. 24,148 (Apr. 30, 1981).
10. 12 U.S.C. §§ 1461-64, *repealed by* the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, § 301, 103 Stat. 277-343 (1989).
11. Testimony of William J. Crawford, California Savings and Loan Commissioner, in *Fraud and Abuse by Insiders, Borrowers, and Appraisers in the California Thrift Industry: Hearings Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the House Comm. on Government Operations*, 100th Cong., 1st Sess., 20-21 (June 13, 1987) (hereafter referred to as *"1987 Fraud Hearings"*).
12. Office of the Legislative Analyst, *Analysis of 1982-83 Budget*, at 343, 345-46.
13. Statement of William J. Crawford, California Savings and Loan Commissioner, in *Savings and Loan Crisis: Field Hearings before the House Comm. on Banking, Finance, and Urban Affairs*, 101st Cong., 1st Sess., 426 (Jan. 12-13, 1989) (hereafter referred to as the *"1989 Crisis Hearings"*).
14. Statement of Assemblymember Nolan regarding AB 3539, Assembly Finance, Insurance, and Commerce Committee (May 4, 1982).
15. See Analysis of AB 3539 prepared by the Assembly Finance, Insurance, and Commerce Committee (Apr. 28, 1982) at 3.
16. Statement of Assemblymember Nolan regarding AB 3539 before the Assembly Finance, Insurance, and Commerce Committee (May 4, 1982).
17. Department of Savings and Loan, Enrolled Bill Report regarding AB 3539 (June 16, 1982) at 2. The State Banking Department also supported the measure, stating that the "current investment restrictions are not necessary" and "the health of the banking industry should not be impacted." State Banking Department, Enrolled Bill Report regarding AB 3539 (June 16, 1982) at 2.
18. Letter from George R. Cook, Vice President, State Government Relations, California Bankers Association, to The Honorable Patrick J. Nolan, re Assembly Bill 3539 (Apr. 30, 1982) at 1. The CBA letter also stated that the elimination of the 10% assets limitation on investment in real property "bothers us," but did not request an amendment of that provision. *Id.* at 3. Later, the CBA dropped its opposition entirely when the bill reached the Governor's desk. Enrolled Bill Memorandum on AB 3539 (June 21, 1982) at 1.
19. *Id.*
20. Chapter 300, Statutes of 1982.
21. Assembly Office of Research, Concurrence in Senate Amendments to AB 2574 (Aug. 19, 1982) at 2.
22. Chapter 845, Statutes of 1982.
23. Assembly Office of Research, Concurrence in Senate Amendments to AB 1434 (Sept. 9, 1983) at 2-3.
24. Analysis of AB 1434 prepared by the Assembly Finance and Insurance Committee (Apr. 8, 1983) at 2.
25. Chapter 1091, Statutes of 1983.
26. See Testimony of Lawrence Taggart, former California Savings and Loan Commissioner, in *1989 Crisis Hearings, supra* note 13, at 152. *See also Boom Now Underway in California in Profitable, State-Chartered S&Ls*, American Banker (Jan. 6, 1983) at 2.
27. Testimony of Lawrence Taggart, *1989 Crisis Hearings, supra* note 13, at 159. He wasn't the only booster of the new laws governing thrifts in California. The Los Angeles branch of a large law firm conducted seminars for persons interested in starting or acquiring a state-chartered S&L, touting the benefits as including: the ability to raise "virtually unlimited amounts of capital," "unparalleled leveraging of funds," "flexible and profitable loan opportunities," and the prestige of being a member of the "financial institutions club." James R.

Butler, Chairman, Financial Institutions Department, Jeffer, Mangels & Butler, *Why Does it Seem Everyone is Buying or Starting a California S&L?* (1984), in *1987 Fraud Hearings, supra* note 11, at 206-21.

28. Testimony of William Black, General Counsel to the Federal Home Loan Bank Board, in *1987 Fraud Hearings, supra* note 11, at 163. Loans for one- to four-unit residential property fell from over 45% of assets in 1982 to under 30% in 1986. Meanwhile, direct investment and ADL loans increased from about 7% of investments in 1982 to 15% in 1986. *Id.* at 157-62. Mr. Black's review also shows that the percentage of direct investment and ADL loans by the 29 California institutions was far above that of the national average. For example, in 1985, the 29 California S&Ls had 20% of their assets in those categories, compared to only 5% for S&Ls nationwide. *Id.* at 160.

29. Mr. Black defined "slow loans" as those which are delinquent for sixty days or more. *Id.* at 163.

30. *Id.* at 154.

31. Statement of James Cirona, President, Federal Home Loan Bank of San Francisco, *1989 Crisis Hearings, supra* note 13, at 294.

32. FHLBB, Regulation of Direct Investment by Insured Institutions, 50 Fed. Reg. 6,912 (Feb. 19, 1985), codified at 12 C.F.R. Part 563.96, which expired on July 13, 1990, pursuant to 12 C.F.R. Part 563.96(h). FHLBB, Net Worth of Financial Institutions, 49 Fed. Reg. 47,852 (Dec. 7, 1984); this proposed regulatory change was never formally adopted.

33. FDIC and FHLBB, Brokered Deposits: Limitations on Deposit Insurance, 48 Fed. Reg. 50,339 (Nov. 1, 1983); adopted 49 Fed. Reg. 13,003 (Apr. 2, 1984); codified at 12 C.F.R. Parts 330.13(b), 564.12(b). These rules were later invalidated in *FAIC Securities, Inc. v. United States*, 595 F.Supp. 73 (D.D.C. 1984), *aff'd*, 768 F.2d 352 (D.C. Cir. 1985).

34. *California S&L Chief Opposes Federal Efforts to Curb Power of State Thrifts*, BNA Daily Report (Mar. 27, 1984) at A-7.

35. *Insurance Delay Irks California S&Ls; Associations Awaiting Regulatory Nod Meet to Trade Stories*, American Banker (Nov. 10, 1983) at 3.

36. *Give New Thrift Powers a Chance, Says Ray Martin, Head of Calif. League*, American Banker (Oct. 4, 1983) at 3.

37. Office of Thrift Supervision, *Federal Agency Interventions Since 1980* (as of Aug. 31, 1990).

38. *Regulators Close 2 State Thrifts, Transfer Deposits*, Los Angeles Times (Feb. 27, 1988), Business Section at 4.

39. *Banking Regulators Seized Mt. Whitney Savings*, Los Angeles Times (Feb. 13, 1986), Business Section at 2.

40. See Letter from William Black, General Counsel, Federal Home Loan Bank of San Francisco, to Honorable Douglas Barnard Jr. (Nov. 2, 1987), Exhibit A, in *1987 Fraud Hearings, supra* note 11, at 476.

41. *Id.*, Exhibit C, at 480.

42. Prepared Statement of David E. Lundin, Attorney, Finley, Kumble, & Wagner, San Diego, California, in *1987 Fraud Hearings, supra* note 11, at 382-83.

43. *S&L Official Pleads Against Lenient Dierdorff Sentence*, Los Angeles Times (San Diego County Edition) (Jan. 7, 1989), Metro Section, Part II, at 1. *See also Wanted: "Bank Cops" Packing Accountants' Tools*, American Banker (Feb. 27, 1989) at 2.

44. *American Savings Ends Home Savings' 28-Year Reign as Nation's Top S&L: First in Deposits and Assets*, American Banker (Feb. 28, 1984) at 1.

45. *The Renaissance of American Savings & Loan; Its 1989 Profit is the Envy of the Industry, But It Took the Resources of Robert M. Bass, the Leadership of Mario J. Antoci and $1.7 Billion from Taxpayers to Get There*, Los Angeles Times (Feb. 5, 1990), Business Section at 1.

46. *Lincoln S&L Posts a $163.9 Million Loss*, Los Angeles Times (Sept. 28, 1990), Business Section at 2.

47. *Keating Indicted for Fraud, Jailed: Three Associates at Lincoln Also Are Charged. A Grand Jury Says They Victimized Investors in the Sale of $200 Million in Bonds*, Los Angeles Times (Sept. 19, 1990) at 1.

48. Briefing Memorandum, California Thrift Industry/Insider Misconduct Hearing, in *1987 Fraud Hearings, supra* note 11, at 450.

49. *Id.* at 9 (emphasis original).

50. See General Accounting Office, *Wrongdoing, Fraud Main Factor in Thrift Industry Crisis: Report to Congress* (Mar. 22, 1989), reprinted in *Investigation of Lincoln Savings & Loan Association: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 1st Sess., 521 (Oct. 26, 1989).

51. *Id.* at 485.

52. *Id* at 505.

53. *See supra* note 1.

54. Pub. L. No. 101-73, 103 Stat. 183 (1989).

55. 136 Cong. Rec. 73 (June 11, 1990).

56. 12 U.S.C. § 1462 *et seq.*

57. 12 U.S.C. § 1817.

58. 12 U.S.C. § 1821.

59. 12 U.S.C. § 1464(t).

60. 12 U.S.C. § 1464(t)(6).

61. 12 U.S.C. § 1464(a).

62. 12 U.S.C. § 1831e.

63. *Id.*

64. 12 U.S.C. § 1464(c)(2)(B).

65. 12 U.S.C. § 1468.

66. 12 U.S.C. § 1831f.

67. 12 U.S.C. § 1878.

68. 12 U.S.C. § 1818.

69. 12 U.S.C. § 1467a(m)(1).

70. 12 U.S.C. § 1467a(m)(3).

71. 136 Cong. Rec. 73 (June 11, 1990) (statement of Sen. Riegle, Table A).

72. 48 Stat. 1246 (1934). FSLIC was established in section 402 of the National Housing Act (12 U.S.C. § 1725), and was abolished by FIRREA, Pub. L. No. 101-73, Title VII, § 703(a), Aug. 9, 1989, 103 Stat. 415.

73. For a more complete itemization of official contribution filings by the savings and loan industry, see *Clearance Sale of the Decade: The Role of California Elected Officials in the S&L Scandal*, California Common Cause and Public Citizen (October 1990).

74. The California Department of Savings and Loan is again an agency on the decline. With a large number of state-chartered institutions either out of business or under government control, its assessment base has again dropped dramatically. The Department's total staff is decreasing. The Legislative Analyst recently recommended that (1) the legislature terminate the chartering provisions under the Savings Association Law, (2) existing state-chartered S&Ls be required to convert to federal charters over time, and (3) in the interim, DSL be merged with the State Banking Department to form a new Department of Financial Institutions. Legislative Analyst, *Analysis of the 1990-91 Budget Bill*, at 249.