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S. 113 and S. 143: Ohio's Response to the Savings and Loan Crisis & Analysis of the Causes, Problems, and Solutions to the S & L Crisis

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LEGISLATION NOTES

S. 113 and S. 143: OHIO'S RESPONSE TO THE SAVINGS AND LOAN CRISIS & ANALYSIS OF THE CAUSES, PROBLEMS, AND SOLUTIONS TO THE S & L CRISIS

I. INTRODUCTION

On a cold March night, hundreds of anxious depositors camped outside their savings and loan institutions awaiting entry and retrieval of their savings. With the dawn came the word that there would be no entry; the doors of these institutions would remain closed for an indefinite period of time, leaving depositors uncertain as to the fate of their money. This sounds like a tale of the Great Depression of the 1930's, but these events occurred in Ohio—in 1985.

In the past two years, Ohio's state-chartered savings and loans (S & Ls) have undergone a crisis in confidence surpassed in magnitude only by that of the Great Depression.[1] On March 15, 1985, spurred by the run on Home State Savings Bank and other Ohio S & Ls,[2] Governor Richard F. Celeste declared a "bank holiday" for all S & Ls insured by the Ohio Deposit Guarantee Fund (ODGF).[3] This bank holiday lasted anywhere from a few days to several months depending upon the S & L involved.[4] It resulted in both hardship to the public[5] and massive image problems for the already troubled S & L industry.[6]

In response to this crisis, the Ohio Legislature unleashed an attack

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1. *See* Forsythe, *Bank Holiday: Ohio Closes State's S&L's as Depositors Panic*, Barrons, Mar. 18, 1985, at 15, col. 1.

2. *Protecting the Depositor: Report and Recommendations of the Joint Select Committee on Savings and Loans*, 116th Ohio General Assembly 7 (1986) [hereinafter *Protecting the Depositor*].

3. *After Weeks of Effort, Home State Parachute Opens*, Dayton Daily News, May 22, 1985, at 1, col. 2, col. 3–4 [hereinafter *Home State Parachute*].

4. *See Protecting the Depositor, supra* note 2, at app. A (for a complete listing of the current status of the 70 ODGF institutions ordered closed by Governor Celeste).

5. *See, e.g.*, Cook, Deveny, Riemer, Schiller & Wallace, *Tremors from Ohio's Bank Run: Independence—And Insecurity—Will Yield to a Federal Safety Net*, BUS. WEEK, Apr. 1, 1985, at 30 [hereinafter Cook].

6. *See* Levin, *Ohio S&Ls Bank on Ads*, Advertising Age, Mar. 25, 1985, at 113. Upon reopening, many of Ohio's state-chartered institutions engaged in extensive media campaigns aimed at restoring the public's confidence in their stability. *Id.* These campaigns ran the gamut from celebrity spokespersons to promotional t-shirts. *Id.* One rather inventive institution offered to pay a portion of its new deposits to an African hunger relief fund. *Id. See also* Meyers, *New Theme from S&L's: Trust Us*, Advertising Age, June 3, 1985, at 49.

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aimed at restoring the public's confidence in state-chartered institutions by promoting the successful reopening of those institutions ordered closed by Governor Celeste. Substitute Senate Bill Number 113 (S. 113)[7] created the Savings and Loan Stabilization Special Account,[8] known as the "SLAC fund," originally intended to be used to aid in the creation of a new private guarantee fund and ultimately used to aid those S & Ls which were unable to meet the requirements for federal insurance.[9] Amended Substitute Senate Bill Number 143 (S. 143)[10] organized the Savings and Loan Assurance Corporation,[11] the body through which monies from the SLAC fund would flow to qualified S & Ls.[12] Further, S. 143 facilitated the conversion of S & Ls to credit unions and banks and the merger of S & Ls with existing credit unions and banks.[13]

This note will first attempt to explain the events which led to the Ohio S & L crisis.[14] Second, it will provide a detailed analysis of S. 113[15] and S. 143,[16] the primary legislation aimed at ending the crisis.[17] Third, this note will analyze the success of the methods employed by the Ohio Legislature.[18] It will also consider the causes of similar crises in other states and suggest some overall solutions.[19]

II. Background

A. The Troubled Savings and Loan Industry

Underlying the problems faced by Ohio's state-chartered S & Ls are recent problems faced by the S & L industry as a whole. At the root of these problems is the basic financial structure of such institutions.[20]

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7. Act of March 13, 1985, 1985 Ohio Legis. Serv. 5-3 (Baldwin) (codified at Ohio Rev. Code Ann. §§ 1151.01, 1157.11 (Page Supp. 1985)).

8. Ohio Rev. Code Ann. § 1157.11 (Page Supp. 1985).

9. *See infra* notes 58–64, 84–89 and accompanying text.

10. Act of April 6, 1985, 1985 Ohio Legis. Serv. 5-32 (Baldwin) (codified at Ohio Rev. Code Ann. §§ 1155.23–1155.31 (Page Supp. 1985)).

11. Ohio Rev. Code Ann. §§ 1155.23–1155.24 (Page Supp. 1985).

12. *Id.* § 1155.25

13. *Id.* §§ 1155.29, 1155.31.

14. *See infra* notes 33–55 and accompanying text

15. Act of March 13, 1985, 1985 Ohio Legis. Serv. 5-3 (Baldwin) (codified at Ohio Rev. Code Ann. § 1151.01, 1157.11 (Page Supp. 1985)).

16. Act of April 6, 1985, 1985 Ohio Legis. Serv. 5-32 (Baldwin) (codified at Ohio Rev. Code Ann. §§ 11551.23–1155.31 (Page Supp. 1985)).

17. *See infra* notes 58–64, 83–92 and accompanying text.

18. *See infra* notes 97–143 and accompanying text.

19. *See infra* notes 144–284 and accompanying text.

20. One must keep in mind the fact that the assets of a S & L institution basically consist of mortgage loans and small amounts of cash and securities, while its liabilities basically consist of deposits (passbook accounts, certificates of deposit, etc.). B. Gup, Financial Intermediaries: An

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> The economic function of savings and loan associations is to obtain savings from the public and invest the bulk of those funds in home financing. Accordingly, savings and loan associations have a specialized structure, with assets that consist of long-term mortgages and liabilities that consist of short-term deposits. This imbalance between the maturity structure of their assets and liabilities has contributed to the financial instability of savings and loan institutions.[21]

The past two decades have not been an easy time for the S & L industry. Since 1966, interest rates have been steadily rising.[22] S & Ls have faced stiff competition for depositors' funds from other types of investments, such as government securities and bank certificates of deposit.[23] S & Ls needed to increase the rate of interest offered to depositors simply to meet this competition.[24]

By increasing the rate of interest paid, S & Ls increased their

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INTRODUCTION 106, 110–111 (2d ed. 1980).

21. *Id.* at 100. The problems faced by S & Ls might best be understood through the use of the following hypothetical. In 1965, Ms. Smith receives an inheritance of $10,000, which she promptly deposits in Neighborhood State Savings and Loan (Neighborhood). In return for the use of her funds, Neighborhood agrees to pay Ms. Smith 4% annual interest. At the same time, Mr. Jones decides to purchase a home. He applies to Neighborhood for a 30-year mortgage in the amount of $10,000. Neighborhood agrees to provide Mr. Jones the needed funds at a price of 5% per annum ($500 per year). Ms. Smith is satisfied for she receives $400 per year from her investment. Neighborhood is satisfied as it makes a profit of $100 per year from the two transactions. In the 1970's, however, rapidly rising inflation and interest rates led to trouble. One day Ms. Smith realizes that she can invest in federal treasury bills and receive 8% interest per year. As these bills are backed by the federal government, her savings will be perfectly secure. In addition, she will receive $400 more each year in interest than she is currently receiving from Neighborhood. The only way that Neighborhood can prevent the withdrawal of her funds is to match the interest rate offered by the treasury bills. To do so, however, increases Neighborhood's cost of borrowing from Ms. Smith by $400 per year, making its total cost $800 per year. Neighborhood's problem arises from the fact that it cannot increase its revenues to match its increase in costs. Mr. Jones still has 16 years in which to retire his mortgage. Neighborhood's revenues are fixed for that period at $500. Now instead of making a profit of $100 per year from the two transactions, Neighborhood is incurring a loss of $300 per year, and there is very little Neighborhood can do to rectify the situation.

22. W. WOERHEIDE, THE SAVINGS AND LOAN INDUSTRY: CURRENT PROBLEMS AND POSSIBLE SOLUTIONS 8 (1984).

23. *Id.* This type of occurrence is known as *disintermediation*, which means that investors invest funds directly in higher yielding marketable securities, rather than allowing financial institutions (intermediaries) to do it for them. B. GUP, supra note 20, at 111. In essence, investors are cutting out the middleman (and his fee).

24. B. GUP, *supra* note 20, at 108. It must be noted, however, that it was not always legally possible for S & L institutions to increase the rate of interest offered to depositors. Until March 31, 1986, the Federal Home Loan Bank Board (FHLBB) imposed a ceiling on the maximum interest rates payable on time and savings deposits at *federally insured* institutions. *Id.* at 212–213. Disintermediation occurred when market rates of interest exceeded the ceiling set by the FHLBB. *Id.* at 212. One of the biggest advantages of ODGF membership was the fact that member institutions were *not* subject to the ceiling imposed on federally insured institutions. Cook, *supra* note 5, at 29–30. One member institution used a passbook rate which fluctuated between 9.5% and 12% to increase its assets from $15 million to $350 million in just three years. *Id.*

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costs.[25] There was, however, no corresponding increase in income. The asset portfolios of most S & Ls were made up largely of fixed-rate mortgages obtained in prior years when interest rates were lower.[26] S & L institutions were thus faced with an impossible choice: they could hold interest rates down and lose depositors, or they could increase interest rates and lose profits.

Despite the many problems faced by S & Ls, there was reason to hope for increasing stability. Recent legislation has allowed S & Ls to offer more services so that they can better compete with banks.[27] In addition, such legislation has enabled such institutions to reduce or shift the risk of widely fluctuating interest rates.[28] The Depository Institutions Deregulation and Monetary Control Act (DIDMCA),[29] which was signed into law in March of 1980, blurred the line between banks and S & Ls, allowing federal S & Ls to offer a variety of new services including NOW accounts.[30] Additional legislation has allowed S & L institutions to make commercial loans totaling up to ten percent of their assets, make commercial real estate loans totaling up to forty percent of their assets, and make consumer loans of up to thirty percent of their assets.[31] Such short-term loans are considered less risky with regard to fluctuations in interest rates. S & L institutions have also been able to shift some of the risk of fluctuating interest rates to their mortgagors through the use of variable-rate mortgages.[32] Despite these improvements, the S & L industry as a whole has remained troubled. The problems faced by Ohio's state-chartered S & Ls mirror those faced nationwide.

B. *The Structure of Ohio's S & L Industry*

In Ohio, as elsewhere in the United States, S & Ls may be organized under either a federal or a state charter.[33] Institutions operating

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25. B. GUP, *supra* note 20, at 108.

26. *Id.*

27. *See infra* notes 29–30 and accompanying text.

28. *See infra* notes 31–32 and accomanying text.

29. 12 U.S.C.A. §§ 3501–3524 (1982).

30. *See* W. WOERHEIDE, *supra* note 22, at 19–20. Negotiable Orders of Withdrawal (better known as NOW accounts) are "savings deposits from which the depositor may have funds transferred to a designated party by simply sending the savings bank a checklike form, the NOW." R. WAUD, MACROECONOMICS 230 (1980). Such accounts are, at least from the point of view of the consumer, checking accounts. This type of account allows savings and loan institutions to reduce costs by compensating for lower interest rates through the provision of more services.

31. W. WOERHEIDE, *supra* note 22, at 22. *See also* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified at scattered sections of titles 11, 12, 15, 20 & 42 of U.S.C.).

32. B. GUP, *supra* note 20, at 117–18.

33. *Id.* at 106 ("The term *charter* means a written document granting the financial

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under a federal charter must belong to the Federal Home Loan Bank System (FHLBS)[34] and must be insured by the Federal Savings and Loan Insurance Corporation (FSLIC).[35] Prior to the recent crisis, those institutions operating under a state charter could, but need not, belong to the FHLBS and be insured by the FSLIC.[36]

In the alternative, such institutions could be insured by the Ohio Deposit Guarantee Fund (ODGF), a private organization.[37] "The Ohio Deposit Guarantee Fund, while organized according to provisions of Ohio law, is not a state agency. The state did regulate and examine ODGF, but no state funds, faith or credit insured ODGF depositors."[38] Each member institution of the ODGF was required to deposit two percent of its assets in the fund,[39] which provided unlimited insurance coverage.[40] The ODGF did not seek to distribute any of the risk by seeking reinsurance.[41]

C. *The Final Straw*

1. The Collapse of Home State Savings and Loan

The demise of the ODGF was initiated by the run on Home State Savings Bank, the fund's largest institution.[42] Home State's run was the result of the collapse of ESM Government Securities, Inc. (ESM) of Fort Lauderdale, Florida.[43] ESM was engaged in the business of

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intermediary certain functions, rights, and privileges.").

34. *Id.* The Federal Home Loan Bank System is an agency of the federal government charged with acting as a central credit facility and regulatory agency for member mortgage lending institutions. *Id. See generally Federal Home Loan Bank Board*, in FEDERAL REGULATORY DIRECTORY 492 (C. McGovern ed. 1986).

35. B. GUP, *supra* note 20, at 106. "It shall be the duty of the Corporation to insure the accounts of all Federal savings and loan associations, and all Federal savings banks, except for Federal savings banks the deposits of which are insured by the Federal Deposit Insurance Corporation." 12 U.S.C. § 1726(a)(1) (1982).

36. OHIO REV. CODE ANN. § 1151.41 (Page 1968). *See also* 12 U.S.C. § 1726(a)(2) (1982).

37. *See* OHIO REV. CODE ANN. § 1151.41 (Page 1968) (provides a listing of the laws governing private deposit guarantee institutions). Section 1151.89 of the Ohio Revised Code is of special interest as it charges the superintendent of building and loan associations with the task of making a yearly examination into the affairs of each member institution. *Id.* § 1151.89.

38. *Protecting the Depositor*, *supra* note 2, at 6 n.1 (1986).

39. Linnen, *Banking Crisis Sparks Questions About Private Deposit Insurance* 106 SAVINGS INSTITUTIONS, May 1985, at 54, 57.

40. Cook, *supra* note 5, at 30. The ODGF may have been able to obtain reinsurance by seeking backing from a group of underwriters, each of whom would assume the risk for only a small percentage of the fund. In effect the insurance fund would seek insurance from others for its own assets.

41. Linnen, *supra* note 39, at 57.

42. *Id.* at 54.

43. *See* Forsythe, *supra* note 1, at 15, col. 1. The Home State/ESM connection was created by financier Marvin Warner, former U.S. ambassador to Sweden, who owned Home State and

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buying and selling securities repurchase agreements, a form of short-term lending.[44] Municipalities with excess funds purchased securities owned by ESM in return for ESM's promise to buy the securities back on a particular date at a higher price.[45] This type of agreement is commonly known as a "term repo."[46] Financial institutions in need of short-term loans sold securities, which they owned, to ESM and in return promised to buy the securities back on a particular date at a higher price.[47] This type of agreement is commonly known as a "reverse repo."[48]

A fundamental element in ESM's eventual collapse was the fact that loans *to* ESM from municipalities exceeded loans *by* ESM to financial institutions by more than $450 million.[49] Also contributing to the collapse was the fact that municipalities simply did not take possession of the securities they purchased[50] and the fact that financial institutions, such as Home State, provided securities far in excess of the value of the loans they received.[51] On March 4, 1985, the Securities and Exchange Commission sued to place ESM in receivership[52] thereby rendering Home State's reverse repos worthless. All of ESM's assets

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was a major investor in ESM. *Aftershocks: Results of a $300 Million Crash*, TIME, Mar. 25, 1985, at 57. Warner had allegedly pulled out of ESM by January of 1985, taking $4.4 million in profits with him. Cook, Crock, Engardio, Robbins, Templeman & Wallace, *The Rise and Fall of Marvin Warner*, BUS. WEEK, May 6, 1985, at 104, 106. The financier currently faces criminal charges for the alleged illegal transfer of one hundred million dollars in Home State funds to ESM. McInnis, *Ripples from Home State Spilling into Many Courts*, Dayton Daily News, Mar. 2, 1986, at A14, col. 4. In a separate civil suit filed by the State of Ohio against Warner, it is maintained that Warner received favorable treatment with regard to his personal investments as a result of the Home State deal. *Id.* Warner was also connected with Ronnie Ewton, one of ESM's founders, currently under indictment for obtaining Home State funds through the misrepresentation of ESM's financial condition, and two former Home State presidents, Burton Bongard and David Schiebel, charged with illegally transferring Home State funds. *The Players*, Dayton Daily News, Mar. 2, 1986, at A14, col. 3. The most tragic figure is that of Stephen Arky, Marvin Warner's son-in-law and former chief counsel for ESM, who committed suicide in July of 1985. *Id.*

44. *Protecting the Depositor, supra* note 2, at 2.

45. *Id.*

46. *Id.*

47. *Id.* at 2–3.

48. *Id.* at 2.

49. *Id.* at 3. ESM simply did not have the collateral needed to cover all of its loans.

50. *Id.* As these municipalities were not taking possession of their securities, they could be used as collateral for other loans to ESM.

51. *Id.* "Home State had heavily overcollateralized loans it received via reverse repos with ESM by delivering to that broker-dealer securities with a market value far in excess of the cash it received". *Id.* at 5.

52. *Home State Parachute, supra* note 3, at 1, col. 2. A receiver is "[a] person appointed by a court to manage property in litigation or the affairs of a bankrupt. In bankruptcy or state court proceeding, one who is empowered to take charge of the assets of an insolvent person or business and preserve them for sale and distribution to creditors." BLACK'S LAW DICTIONARY 1140 (5th ed. 1979).

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were frozen.[53] As a result, Home State sustained a loss exceeding $144 million.[54] This loss was more than enough to bankrupt the $136 million ODGF,[55] leaving its other member institutions uninsured.

2. The Domino Effect

By March 6, 1985, news of Home State's financial difficulties had spread and depositors began a run on the institution.[56] The run continued through March 8, 1985, when Home State officials announced that the institution would remain closed until a buyer could be found.[57] State officials hoped to avoid similar runs on other ODGF institutions by creating an new, *private* savings association guarantee fund to protect ODGF's seventy remaining members.[58] Substitute Senate Bill Number 113 (S. 113)[59] created the Savings and Loan Stabilization Special Account,[60] which was intended to provide this new guarantee fund with $50 million[61] in state monies derived from excess lottery profits and unclaimed funds.[62] The Ohio Legislature, however, was not establishing a new state-based insurance system. Each institution joining this new fund was to contribute one percent of its assets.[63] Total contributions from member institutions were expected to total $40 million.[64]

The steps taken by state officials to "beef-up" ODGF institutions' backing and to calm the public, however, were not sufficient to prevent a run on these institutions.[65] For example by Thursday, March 14, 1985, one Cincinnati savings association had paid out 15% of its assets

53. *Protecting the Depositor*, *supra* note 2, at 1.

54. *Id.* at 5. It should be noted that Home State Savings Bank was not the only Ohio entity injured by the collapse of ESM. "The city of Toledo, it was soon learned, was party to a $19.2 million term repurchase agreement with ESM. Toledo had not taken effective possession or control of the securities it bought with it's citizens' money." *Id.*

55. *ESM Triggers Crisis*, 106 SAVINGS INSTITUTIONS, Apr. 1985, at 11.

56. *Home State Parachute*, *supra* note 3, at 1, col. 3.

57. *Id.*

58. *Protecting the Depositor*, *supra* note 2, at 7. *See also* R. Finan, *Legislation Sought to Set Up a New S&L Guarantee Fund*, Press Release (Mar. 11, 1985).

59. Act of March 13, 1985, 1985 Ohio Legis Serv. 5-3 (Baldwin) (codified at OHIO REV. CODE ANN. §§ 1151.01, 1157.11 (Page Supp. 1985)).

60. Act of March 13, 1985, § 3, 1985 Ohio Legis. Serv. 5-4.

61. *See* Forsythe, *supra* note 1, at 15, col. 2.

62. *Protecting the Depositor*, *supra* note 2, at 7. It should be noted that any state monies provided through this special account to any new guarantee fund were to be in the form of a loan. Act of March 13, 1985, § 4, 1985 Ohio Legis. Serv. 5-4 (1985).

63. Memorandum from L. Sotos, legislative intern, to Senate Republicans (March 13, 1985) (giving the minutes of the second Financial Institutions and Insurance Committee hearing on S. 113) [hereinafter Sotos Memorandum I].

64. *Id.*

65. Forsythe, *supra* note 1, at 15, col. 2.

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to depositors.[66] The situation continued to deteriorate. Before dawn on Friday, March 15th, frightened depositors had lined up outside Cincinnati S & Ls.[67]

At 7:30 a.m.[68] on the morning of March 15th, Governor Richard F. Celeste declared a three-day bank holiday for all ODGF institutions[69] —the nightmare had begun. The cost to depositors of this action is immeasurable. Many local businesses did extend credit to those depositors crippled by the holiday,[70] but such kindness by no means solved all of the problems faced by depositors. One depositor, for example, depended upon her savings to pay the insurance premiums on her car.[71] As a result of the holiday, her policy lapsed and she was unable to drive her car to school and to her job.[72] Other depositors endured similar hardships as they awaited answers from the legislature.

3. The Response of the Ohio Legislature

The Ohio Legislature extended the bank holiday by enacting Amended Substitute Senate Bill Number 119 (S. 119),[73] which required state-chartered institutions, with a few extremely limited exceptions,[74] to obtain insurance provided by the FSLIC or the FDIC.[75] This bill allowed limited withdrawals of up to $750 per month by the deposi-

66. *Institutions Seek Federal Insurance to Resume Service*, 106 Savings Institutions, Apr. 1985, at 6, 7 [hereinafter *Institutions Seek*].

67. Forsythe, *supra* note 1, at 15, col. 2.

68. *Id.* It is important to remember at this point the type of customer to whom a savings and loan association caters. The people camped out on the steps of these savings and loans were not high rollers. They were average citizens who had entrusted their savings to this type of institution because it represented security. A 1985 survey by the United States League of Savings and Loans indicated that 32.4% of responding depositors were motivated to save by the desire for "Rainy day" savings. Spooner, *Savers Survey Sets the Stage for Strategic Planning*, 106 Savings Institutions, May 1985, at 72, 79. Furthermore, 25.8% of responding depositors were saving for retirement and 6.7% were saving for college expenses. *Id.* Clearly the loss of these types of savings could have a devastating effect upon the depositor.

69. *Protecting the Depositor*, *supra* note 2, at 7. Governor Celeste's action was by no means universally accepted as necessary. The runs which led to the holiday were limited to the Cincinnati area. *Institutions Seek*, *supra* note 66, at 7. The management of institutions elsewhere in the state resented being dragged into the mess. *Id.* However, those in the Cincinnati area generally felt that by this point in time the governor had no choice but to step in. *Id.* Further, a recent survey by the University of Akron indicates that 61.46% of Ohioans believe that Governor Celeste's closing of Home State was a good idea. Lane, *Poll Shows Most Now Agree with Home State Handling*, Dayton Daily News, Mar. 24, 1986, at 6, col. 2.

70. Cook, *supra* note 5, at 30.

71. *Id.*

72. *Id.*

73. Act of March 20, 1985, 1985 Ohio Legis. Serv. 5-4 (Baldwin) (codified at Ohio Rev. Code Ann. § 1155.22 (Page Supp. 1985)).

74. *See* Ohio Rev. Code Ann. § 1155.22(B)-(D) (Page Supp. 1985).

75. *Id.* § 1155.22(A).

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tors of closed institutions.[76] S. 119 also allowed institutions to convert to banks if in doing so they would qualify for insurance from the FDIC.[77] Finally, the bill provided that the state funds allocated to the Savings and Loan Stabilization Special Account[78] were to be used to indemnify the FSLIC for any losses incurred by the FSLIC through defaults of former ODGF members accepted for membership by the corporation.[79]

The enactment of S. 119 created a new set of financial problems for the already beleaguered ODGF institutions. The FSLIC requires that new members maintain an average net worth of 5%.[80] ODGF members had already lost the 2% of their assets which were deposited in the guarantee fund.[81] As a result, in order to meet the requirements of the FSLIC and thus qualify for the needed federal insurance, an ODGF institution would have had to have maintained an average net worth of 7% prior to the failure of the fund.[82]

Amended Substitute Senate Bill Number 143 (S. 143),[83] enacted April 6, 1985, was intended to save the thirty-eight S & Ls which were unable to survive independently under existing law.[84] The bill provided for the creation of the Savings and Loan Assurance Corporation,[85] whose board of trustees was to administer the Savings and Loan Stabilization Special Account,[86] known as the "SLAC fund." Further, the Director of Budget and Management was instructed to increase the SLAC fund with the transfer of an additional $10 million derived from liquor profits.[87] This raised the total amount of the SLAC fund to $60 million. The basic idea was to use the SLAC fund to recapitalize ODGF institutions,[88] thus providing them sufficient net worth to obtain federal insurance.[89] Provisions allowing conversion to the credit un-

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76. *Id.* § 1155.22(F). This amount was later increased to $1000 per month by S. 143. Act of April 6, 1985 § 9, 1985 Ohio Legis. Serv. 5-36 (Baldwin 1985).

77. *See* Act of March 20, 1985, §§ 3–4, 1985 Ohio Legis. Service 5-5 to -6 (Baldwin 1985).

78. *See supra* notes 59–62 and accompanying text.

79. Act of March 20, 1985, § 6, 1985 Ohio Legis Serv. 5-6 (Baldwin 1985).

80. *Institutions Seek*, *supra* note 66, at 6.

81. Linnen, *supra* note 39, at 57.

82. *Institutions Seek*, *supra* note 66, at 6.

83. Act of April 6, 1985, 1985 Ohio Legis. Serv. 5-32 (Baldwin) (codified at OHIO REV. CODE ANN. §§ 1155.23–.31 (Page Supp. 1985)).

84. Memorandum from L. Sotos, legislative intern, to Senate Republicans (Apr. 4, 1985) (giving the minutes of the Financial Institutions and Insurance Committee hearing on S. 143) [hereinafter Sotos Memorandum II].

85. Act of April 6, 1985, § 1, 1985 Ohio Legis. Serv. 5-33 (Baldwin) (codified at OHIO REV. CODE ANN. §§ 1155.23–.24 (Page Supp. 1985)).

86. OHIO REV. CODE ANN. § 1155.25 (Page Supp. 1985).

87. Act of April 6, 1985, § 6, 1985 Ohio Legis. Serv. 5-35 to -36 (Baldwin 1985).

88. *See* Sotos Memorandum II, *supra* note 84.

89. *See Governor Signs Bill to Help Closed Thrifts to Reopen*, 57 Gongwer News Serv.,

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ions[90] and banks[91] were also aimed at insuring the availability of federal insurance.[92]

The final legislative action relating to the SLAC fund occurred when the Ohio Legislature enacted Amended Substitute House Bill Number 492 (H. 492),[93] which provided state funds to facilitate the sale of Home State to a private interest.[94] This bill authorized the loan of funds from the Savings and Loan Stabilization Special Account to the newly created Depositor Assurance Corporation (DAC).[95] Ultimately, the DAC fund received $38 million, while the SLAC fund retained $22 million.[96]

III. An Analysis of the Ohio Legislature's Course of Action

The remedial legislation enacted by the Ohio Legislature could be termed "damage control" in that it was an attempt to limit the impact of the Home State debacle.[97] The overriding goal of both S. 113 and S. 143 was to restore the public's confidence in state-chartered S & Ls.[98] To achieve this goal, it was necessary that no depositor lose any of his funds. The Ohio Legislature seems to have achieved this objective—all but one of the ODGF institutions have been authorized to reopen for full service.[99] Further, it was necessary that the public have faith in the long-term stability of the reopened institutions. Regaining public faith required that the legislature provide depositors' savings with the best possible protection. It was also necessary that the ODGF institutions be

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Inc., Ohio Report, Apr. 8, 1985, at 1.

90. OHIO REV. CODE ANN. § 1155.29 (Page Supp. 1985).

91. Act of April 6, 1985, § 12, 1985 Ohio Legis. Serv. 5-36 (Baldwin 1985).

92. Sotos Memorandum II, *supra* note 84. S. 143 was intended to allow savings and loan institutions to "take advantage of 'net worth' as banks do to transfer debt into capital." *Id.*

93. Act of May 21, 1985, 1985 Ohio Legis. Serv. 5-44 (Baldwin) (codified in scattered sections of title 11 of the OHIO REV. CODE ANN. (Page Supp. 1985)).

94. *See McAlister Awards Hunter Savings of Cincinnati Contract to Purchase Home State*, 57 Gongwer News Serv. Inc., Ohio Report, May 29, 1985, at 1.

95. Act of May 29, 1985, § 9, 1985 Ohio Legis. Serv. 5-55 to -56 (Baldwin 1985).

96. Telephone interview with Richard Fahey, Assistant Secretary to the Board of Trustees of the Savings and Loan Assurance Corporation (Feb. 20, 1986) (on file with the University of Dayton Law Review) (hereinafter Fahey interview].

97. *See supra* notes 42–57 and accompanying text (giving an account of the Home State Savings Bank collapse).

98. *See supra* notes 58–92 and accompanying text. It should be noted that ODGF depositors were not the only persons whose confidence was shaken by the closings. Ohio's bank holiday had a surprisingly strong impact abroad, triggering a devaluation of the United States dollar and an increase in the value of gold. *The S & L Collapse Heard 'Round the World*, BUS. WEEK, Apr. 1, 1985. "In just two days the dollar sank 4% against the West German mark and 9% against the British pound. . . .[Gold] soared to $340 per oz. from $307 in 12 hours." *Id.*

99. *See Protecting the Depositor*, *supra* note 2, at app. A. Home State Savings Bank of Dayton, which was closed prior to March 15, 1985, is currently owned by the State of Ohio. It remains closed. *Id.*

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reopened as soon as possible. Finally, the steps taken to achieve each of the last two objectives, safety and speed, had to be reconciled, although they were difficult to effectuate jointly.

A. *The Protection Afforded by S. 113*

Even a cursory examination of the events surrounding the enactment of S. 113[100] clearly demonstrates that the Home State collapse caught the Ohio Legislature unprepared to take any definite action.[101] The legislature began with the intention of creating a new private guarantee fund.[102] However, within three days it had abandoned this idea in favor of requiring that state-chartered institutions be federally insured.[103] The source of the legislative confusion was the question of which type of fund is best equipped to protect depositors. Perhaps more important, however, is the question of which type of fund depositors *perceive* as providing the best protection.

In enacting S. 113 the Ohio Legislature was attempting to mitigate the effect of the Home State collapse.[104] The failure of Home State did not necessarily have to lead to the ruin of the entire private insurance system.[105] The key to saving the system would have been the prevention of runs on the other ODGF members.[106] S. 113 failed to serve the purpose for which it was primarily created;[107] it failed to calm the public fears resulting from the Home State crisis.[108]

The idea of creating a new private insurance corporation was not entirely without merit.[109] It is true that many private insurance funds

100. Act of March 13, 1985, 1985 Ohio Legis. Serv. 5-3 (Baldwin) (codified at OHIO REV. CODE ANN. §§ 1151.01, 1157.11 (Page Supp. 1985)).

101. *See supra* notes 58–79 and accompanying text.

102. *See supra* notes 58–64 and accompanying text.

103. *See supra* notes 73–75 and accompanying text.

104. *See supra* note 58 and accompanying text.

105. One possible solution was for the ODGF members themselves to cover Home State's losses and reopen the firm under the ODGF's auspices. *See* Telephone interview with George L. McGuire, President of the Anchor Savings Association, Vice-president of the Savings and Loan Assurance Corporation, President of the Savings and Loan League of Southwest Ohio (Mar. 12, 1986) (interview on file with University of Dayton Law Review) [hereinafter McGuire interview]. Such action might well have preserved the public's confidence in ODGF and its members. *Id.* However, many members were either unable or unwilling to risk the loss of any more of their assets. *Id.*

106. It may well be that a greater danger was posed to ODGF institutions by the reaction of ODGF depositors to the Home State collapse than by the collapse itself. Even a financially healthy institution may be hard pressed to survive a run by depositors. The problem is not that such an institution does not have sufficient assets, but that the institution does not keep the bulk of its assets in liquid form. Most of its assets are tied up in long-term investments such as mortgages. *See supra* notes 20–21 and accompanying text.

107. *See supra* notes 58–61 and accompanying text.

108. *See supra* notes 65–67 and accompanying text.

109. The benefits of requiring federal insurance are not without their costs. McGuire inter-

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hold reserves proportionately larger than the federal bank insurance funds.[110] Such was the case with the ODGF.[111] Its fund, as a percentage of deposits, was 3%,[112] while that of the FDIC is only 0.7%.[113] What makes federal insurance so attractive, however, is the fact that both the FSLIC and the FDIC (the FSLIC's banking counterpart) have the full faith and credit of the United States government behind them.[114] Even if these funds fail, the United States always has the power to provide more money.

S. 113 provided no such safety net for depositors. The SLAC fund was clearly intended to be used only as a loan.[115] There was seemingly nothing to prevent the new guarantee fund from meeting the same fate at that of the ODGF. Part of S. 113's failure lies in the Ohio Constitution, which forbids giving state credit to a private entity[116] such that the legislature was not able at least to partially back the fund. Many depositors were shocked to learn that the ODGF was not a state insurance organization.[117] Depositors lost faith when they learned that the ODGF was not in fact backed by the state.[118] State backing may not have provided quite the same degree of protection as federal backing, but it could have given depositors some sense of security.

If the degree of protection offered is the criteria for judging the viability of private insurance versus federal insurance, the Ohio legislature was probably correct in abandoning the idea of a new private guarantee fund. No private insurance fund could compete with the pro-

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view, *supra* note 106. Among those who paid the price were depositors in certain small Cincinnati "neighborhood" S & L institutions. *Id.* Many of these institutions were only open part-time and in many ways resembled a credit union for residents of their own small section of Cincinnati. *Id.* Such institutions were able to provide greater flexibility to depositors and lenders because of their lifetime connection with these persons. *Id.* Most of these institutions no longer exist independently because they were unable to meet federal insurance requirements with regard to such things as the number of days per week during which a S & L must operate, the hours during which a S & L must be open, etc. *Id.* *See also infra* notes 251–52 and accompanying text.

110. *See* Cook, *supra* note 5, at 29.

111. *Where There Is No Federal Safety Net for Savings*, Bus. Week, Apr. 1, 1985, at 30.

112. *Id.*

113. *Id.*

114. Cook, *supra* note 5, at 29.

115. Act of March 13, 1985, § 4, 1985 Ohio Legis. Serv. 5-4 (Baldwin 1985).

116. *Institutions Seek*, *supra* note 66, at 9. The Ohio Constitution states in pertinent part:

> The credit of the state shall not, in any manner, be given or loaned to, or in aid of, any individual association or corporation whatever; nor shall the state ever hereafter become a joint owner, or stockholder, in any company or association in this state, or elsewhere, formed for any purpose whatever.

Ohio Const. art. VIII, § 4.

117. Forsythe, *supra* note 1, at 15, col. 2.

118. *Id.* "The Ohio run 'proves the value of federal deposit insurance. . . .' The peace of mind provided by the $100,000 insurance precludes 'irrational panics' such as the one that struck Ohio thrifts." *Id.* at 66, col.1.

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tection offered by the complete backing of the federal government. Further, after the trauma of Home State and the resulting bank holiday, it is questionable whether the public could ever again fully trust a private guarantee fund.[119] Nervous depositors do not make for a stable S & L industry. The question which remains, however, is whether after deciding to require federal insurance, the state did enough to help S & Ls acquire federal insurance.

B. The Adequacy of S. 143

The advantage in requiring insurance coverage provided by the FSLIC is that it does indeed provide a great deal of protection. The disadvantage is that such coverage is not quickly and easily obtainable.[120] Despite the more than two hundred Federal Home Loan Bank examiners provided by the FSLIC to Ohio,[121] final approval of insurance applications in some cases took months. S. 119,[122] however, provided for the reopening of institutions which had applied for federal insurance and which the Superintendent of Building and Loan Associations found would probably qualify for such insurance.[123] As a result, the ODGF institutions which were financially strong faced few problems in obtaining a rapid reopening.

Unfortunately, thirty-eight of the original seventy ODGF institutions were not able to meet the federal requirements.[124] Many had had their asset base destroyed by the collapse of the ODGF.[125] It was for these institutions that S. 143[126] was enacted.[127] Three goals were of

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119. *See, e.g.*, *Linnen*, *supra* note 39, at 54. For a further discussion of the merits of private insurance versus federal insurance see *infra* notes 242–263.

120. The sad case of Valleywood Savings Association provides a fine example of this problem. One year after Governor Celeste's declaration of the bank holiday, Valleywood's 3,400 depositors were still denied full access to their money. *Savings Depositors Press for Solution*, Dayton Daily News, Mar. 15, 1986, at 5, col. 5. On March 14, 1986, one hundred of the disgruntled depositors marched in protest in front of a Valleywood branch in downtown Cincinnati. *Id.* Depositors demanded immediate state action to bailout the institution. *Id.* It was not until April 16, 1986, that Governor Richard Celeste's office announced the sale of Valleywood. *Ohio Thrift Unit*, N.Y. Times, Apr. 17, 1986, at D4, col. 5. "Suburban Federal Savings & Loan Association, Cincinnati, bought the four Valleywood offices and assumed liability for deposits . . . ." The buyer also planned to reopen them for full service. *Last of Ohio's Closed S&Ls Is Sold and Set to Reopen*, Wall St. J., Apr. 17, 1986, at 38, col. 3.

121. *See* Cook, *supra* note 5, at 30. These examiners extended great effort in examining the financial condition of ODGF institutions in order to facilitate FSLIC approval (and the resultant institution reopenings) as quickly as possible. McGuire interview, *supra* note 105.

122. Act of March 20, 1985, 1985 Ohio Legis. Serv. 5-4 (Baldwin) (codified at OHIO REV. CODE ANN. § 1155.22 (Page Supp. 1985)).

123. *Id.*

124. *See supra* note 84 and accompanying text.

125. *See supra* note 81 and accompanying text.

126. Act of April 6, 1985, 1985 Ohio Legis. Serv. 5-32 (Baldwin) (codified at OHIO REV. CODE ANN. §§ 1155.23-.31 (Page Supp. 1985)).

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paramount importance to these institutions. First, of course, they wanted to survive.[128] Second, many of these institutions desired to remain independent.[129] It is important to remember that their problems were not brought about by their own fiscal irresponsibility but by that of Home State. These institutions lost 2% of their assets because the ODGF failed,[130] through no fault of their own. Finally, these institutions needed reopenings as soon as possible. Every day that they were closed both they and their depositors lost money. More importantly, faith in the stability of these institutions was continuing erode.

S. 143 did aid a number of ODGF institutions. Some institutions merged,[131] some were acquired by banks,[132] and some elected to convert to bank form.[133] Seven institutions were able to take advantage of the $22 million available in SLAC funds.[134] A possible problem, however, arose with the legislature's action in shifting $38 million in funds earmarked for the SLAC fund to the DAC fund.[135] At the Financial Institutions and Insurance Committee hearing on S. 143, representatives of one ODGF institution testified as to the insitution's financial strength prior to the closing, its desire to remain independent, and its need for a loan to meet FSLIC requirements.[136] Subsequently, this in-

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127. *See* Sotos Memorandum II, *supra* note 84.

128. *Id.*

129. *Id.*

130. *See* Linnen, *supra* note 39, at 57.

131. *See Protecting the Depositor*, *supra* note 2, at app. A. For example, Buckeye Building and Loan Company of Gallipolis merged into McArthur Savings and Loan Company of McArthur, and Mt. Healthy Savings and Loan Company of Mt. Healthy merged into Highland Federal Savings and Loan Association of Mariemont. *Id.*

132. *Id.* For example American Savings and Loan Company of Cincinnati, Federated Savings Bank of Lockland, First State Savings and Loan Association of Columbus, Investor Savings Bank of Columbus, Mentor Savings Bank of Mentor, and Tri-State Savings and Loan Company of Cincinnati were all acquired by Chase Manhattan Corporation to operate as Chase Bank of Ohio. *Id.*

133. *Id.* For example, Miami Valley Building and Loan Association of Franklin converted to Miami Valley Bank of Southwest Ohio. *Id.*

134. The Savings and Loan Assurance Corporation has issued debentures to the following institutions in the following amounts: The Buckeye Savings & Loan Company, $3,300,000; Cherry Grove Savings & Loan Company, $356,000 (of which only $150,000 was drawn upon); Sycamore Savings & Loan Company, $1,050,000; Midwest Savings Association, $2,550,000; and Anchor Savings Association, $500,000. Letter from Richard P. Fahey, Assistant Secretary to the Board of Trustees of the Savings and Loan Assurance Corporation, to Lori Shaw (Feb. 24, 1986) (on file with the University of Dayton Law Review). All of these debentures were issued for a term of seven years. *Id.* With the exception of The Buckeye Savings & Loan Company, which is paying interest based upon the prime rate plus 1%, each of the institutions is paying interest based upon the prime rate. *Id.* The Savings and Loan Assurance Corporation has issued stock to the following institutions in the following amounts: Citizens Banking Company, $9,800,000; and Peoples of DeGraff, $4,260,000. *Id.*

135. *See supra* notes 93-96 and accompanying text.

136. *See* Sotos Memorandum II, *supra* note 84.

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stitution merged with another institution,[137] which would seem to suggest that money from the SLAC fund may have been unavailable. It hardly seems fair to take money away from innocent depositors in order to bail out the enterprise which caused their difficulties. On the other hand, Home State's eighty-eight thousand depositors[138] were also victims; and as long as Home State remained closed, they would suffer the consequences.[139]

Despite the false starts and confusion,[140] the efforts of the Ohio Legislature to protect the interest of its citizens were admirable. State-chartered S & Ls continue to provide financial services to the People of Ohio. In many respects, these institutions are stronger than ever.[141] They have had to fortify net worth and provide federal insurance for depositors.[142] If restoration of public confidence is the measure by which the legislature is to be judged, it would seem that its efforts were not in vain. A recent survey of Ohioans taken by the University of Akron indicated that 69% of Ohioans are "very confident" in their banking institution; 27% are "somewhat confident" in their banking institution; and only 4% are "not at all confident" in their banking institution.[143] This confidence is all the more remarkable when it is considered that the Ohio S & L crises were not isolated aberrations. The entire S & L industry has been beset by problems that have resulted in crises not only in Ohio, but in other states as well.

IV. S & L Runs in Mississippi, Nebraska, and Maryland

Ohio was not the first state to declare a bank holiday. Mississippi declared a bank holiday in May 1976,[144] closing down all thirty-four privately insured thrift institutions after it was disclosed that Bankers Trust Savings & Loan Association was placed into receivership.[145] Beginning in 1974, Bankers Trust was financially unstable, posting losses of approximately $10,000 each day for two years.[146] By the end of

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137. *See Protecting the Depositor*, *supra* note 2, at app. A.

138. *See* Miller, *Ohio's Nightmare: Collapse of Florida Firm Meant Big Trouble Up North*, Dayton Daily News, Mar. 2, 1986, at A1, col. 1. Over $1 billion in deposits were frozen. *Id.* at col. 2.

139. A majority of Ohioans appear to agree with the bailout. A recent survey by the University of Akron indicates that 56.62% of Ohioans believe that the use of state funds to guarantee the deposits of Home State depositors was appropriate. Lane, *supra* note 69, at 6, col. 2.

140. *See supra* text accompanying notes 100–103.

141. McGuire interview, *supra* note 105.

142. *Id.*

143. Lane, *supra* note 69, at 6, col. 2.

144. Medley, *Banks on the Run*, New Republic, Apr. 15, 1985, at 11, 11.

145. *See* Linnen, *supra* note 39, at 56.

146. Zeller, *Bankers Trust Lost over $10,000 a Day*, Clarion Ledger, July 1, 1976 (available on NewsBank, Inc., Microfiche No. BUS 26:A5) (In 1974, Bankers Trust had losses of $3.3

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1975, Bankers Trust's deficit was more than $1.3 million.[147] In early May 1976, a stockholder filed suit claiming that the thrift was insolvent.[148] These incidents triggered a $6.3 million run on all of Mississippi's privately insured thrifts, threatening to wipe out Mississippi's private insurance fund, American Savings Insurance Company.[149] The governor declared a bank holiday, and on May 20, 1976, state officials appointed a conservator.[150] An audit revealed that Bankers Trust, Mississippi's largest S & L with deposits of $206 million and sixty thousand depositors, had overvalued its assets by $28 million.[151] To remedy the situation, Mississippi required all thrift institutions within the state to obtain federal insurance.[152]

Several years later in November 1983, Nebraska banking officials declared the Lincoln-based Commonwealth Savings Company, the largest thrift in the state, insolvent.[153] The Nebraska Depository Institution Guarantee Corporation (NDIGC) privately insured Commonwealth and thirty two other state-chartered thrifts up to $30,000 per account.[154] These thrifts lent mainly to blue-collar workers who were unable to obtain consumer and real estate loans from commercial banks.[155] Since these loans were riskier, these thrifts were able to charge higher interest rates, thereby reaping a higher rate of return on their money. For a time, Commonwealth and the other thrifts pros-

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million and in 1975, $3.4 million.).

147. *Id.*

148. Linnen, *supra* note 39, at 56 (Insolvency is the inability to pay debts or discharge liabilities.).

149. *Id. See also Insurers in Mississippi Face a Possible Role in Failure of Big S & L*, Wall St. J., Sept. 9, 1976, at 7, col. 2 [hereinafter *Insurers in Mississippi*] (American Savings Insurance Company (ASIC) had only $9 million in assets.).

150. *Parent of S. & L. Ruled Insolvent*, N.Y. Times, June 9, 1976, at 53, col. 4 (A conservator or receiver is one who preserves a corporation's or financial institution's assets.).

151. *Insurers in Mississippi supra* note 149, at 7, col. 2. When a bank overvalues its assets, its financial health appears to be more stable. *Id.* If Bankers Trust were to be liquidated, ASIC would receive the proceeds of the liquidation. *Id.* However, due to overvaluation, ASIC would receive $28 million less than it could expect. *Id.*

152. *Bankers Trust S & L of Mississippi to Pay Some Interest Claims*, Wall St. J., Oct. 8, 1976, at 3, col. 2.

153. Helyar, *Nebraska Bank's Failure Soils Reputation and Threatens to Cost Depositors Millions*, Wall St. J., Dec. 9, 1983, at 33, col. 4. Commonwealth had $77.3 million in assets, $66.9 million in deposits, and 6700 depositors. *Id.* Nebraska's State Department of Banking and Finance took control of Commonwealth, an industrial savings company. *Id. See also* Hawkins, *State Funds Eyed for Depositors*, Des Moines Register, Nov. 27, 1983 (available on NEWSBANK, INC., Microfiche No. BUS 121:C8, at C9) (In the early 1980's, industrial banks prospered because they were able to sidestep federal regulations on interest rates on deposits and sidestep state branching laws.).

154. *Commonwealth Savings Is Declared Insolvent*, Wall St. J., Nov. 2, 1983, at 12, col. 5. NDIGC lacked the reserves to cover losses. *Id.* Since these deposits are privately insured, the federal government is not obligated to bailout the private insurer. *Id.*

155. Helyar, *supra* note 153.

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pered; however, the growth of these thrifts stopped abruptly with the recession and its high rates of interest.[156] The trouble was that these thrifts were locked into thirty-year mortgages at low interest rates, while they still had to offer high rates of interest to attract depositors.[157] In short, expenses exceeded income and the red ink flowed. NDIGC lacked adequate reserves to bailout Commonwealth because the private insurer had recently bailed out several smaller ailing thrifts.[158] Commonwealth was also plagued by inside transactions such as a million dollar loan to the president and his son.[159]

The private guarantee fund, NDIGC, had only $3 million in reserve, while total losses were expected to reach $30 million dollars.[160] As of April 1985, depositors had failed to see a single cent of their savings.[161]

Then came the Ohio debacle. The closing of the Cincinnati-based Home State Savings & Loan sent shock waves through the state's network of non-federally backed thrifts and throughout the banking world.[162] In a replay of Ohio's bank run, depositors of Maryland's S & Ls, covered by private instead of federal insurance, scrambled to withdraw their savings less than two months after Ohio's crisis.

The Maryland crisis began on May 9, 1985, when the Baltimore-based Old Court Savings and Loan suffered a high outflow of deposits.[163] The run was sparked by a newspaper report of a change in top management in Old Court.[164] Frightened Maryland depositors, taking

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156. *Id.*

157. *Id.*

158. Pieper, *State Takeover Painless at Dwight, Niobrara*, Journal & Star (Lincoln, Neb.), Nov. 13, 1983 (available on NEWSBANK, INC., Microfiche No. BUS 121:C12). The Bank of Nebraska was closed and reopened overnight. *Id.* However, in the case of Commonwealth, no one was willing to purchase the ailing thrift and thereby facilitate the reopening promptly. *Id.* Stingly, *Some Trusted Guarantee, Others Copple*, Omaha World Herald, Nov. 27, 1983 (available on NEWSBANK, INC., Microfiche No. BUS 132:C5). In December 1982, Nebraska State Banking Department shut down Dwight Credit Association. *Id.* Over the weekend the bank reopened and "not a beat was missed." *Id.*

159. Helyar, *supra* note 153. Nebraska law limits loans to insiders, officers, and directors to $60,000.

160. Linnen, *supra* note 39, at 56.

161. Dreyfus, *How Safe Are Your Savings?*, MONEY, May 1985, at 56, 58.

162. *See* Koepp, *Putting a Stop to a Stampede*, TIME, Apr. 1, 1985, at 56, 56 (Consumer confidence in the economy dropped in one week from 50.4% to 42%, the largest decline in the survey's 30-year history.); *Ohio Bank Crisis That Ruffled World*, U.S. NEWS & WORLD REP., Apr. 1, 1985, at 11, 11 (On March 19, 1985, the dollar's exchange value decreased by 2.5%, while the price of gold jumped to $339, up $36.).

163. *Maryland Will Run Thrift Unit*, N.Y. Times, May 13, 1985, at D1, col. 6 (Jittery depositors withdrew $10 million on the first day.).

164. Berg, *Maryland Thrift Has a Run*, N.Y. Times, May 10, 1985, at D1, col. 6 (The announcement by Maryland's Attorney General that a criminal investigation was being undertaken also fueled the run.)

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their cue from Ohioans, rushed to withdraw their savings from Old Court, providing an example of just how quickly public confidence had eroded.[165] On May 12, state officials, in an emergency session, appointed a conservator to Old Court to manage its finances.[166] The following day, a negative news report forced a second S & L, Merritt Commercial Savings and Loan Association of Baltimore, into conservatorship.[167] This action precipitated a full-blown, state-wide bank run, spreading to Maryland's other 100 privately insured S & Ls because depositors feared that the $286 million private fund, Maryland Savings-Share Insurance Corporation (MSSIC), would be wiped out by a major run on the $7.2 billion in deposits that it guaranteed.[168]

Immediate action was necessary to reduce the extensive cash outflow and to restore a degree of stability to the state's privately insured thrifts. On May 14, 1985, Maryland's governor issued an executive order limiting withdrawals to $1000 a month per account on all of Maryland's 102 privately insured thrifts.[169] On the same day, the governor called an emergency session of the Maryland General Assembly to preserve the financial stability of the state's banking system.[170] On May 18, four days later, the governor signed seven emergency bills to restore confidence in the troubled thrifts. Among other things, the legislation

165. Berg, *Maryland Limits All Withdrawls from Thrift Unit*, N.Y. Times, May 15, 1985, at A1, col. 1, D19, col. 3. *See Maryland Crisis Fuels Swing to Federal Insurance*, SAVINGS INSTITUTION, June 1985, at 6, 8 [hereinafter *Maryland Crisis*] ("Maryland depositors, already nervous because of the Ohio problems, started withdrawing their money more quickly at the first whiff of trouble.").

166. *Maryland Crisis, supra* note 165.

167. Berg, *Caretaker at Another Thrift Unit—Added Duties for Maryland Conservator*, N.Y. Times, May 14, 1985, at D1, col. 5. Maryland Governor Harry R. Hughes disclosed that 350 federal bank examiners were dispatched to examine Maryland's state-chartered thrifts. *Id.* MSSIC was named as conservator for both Old Court and Merritt Commercial Savings and Loan. *Id.*

168. *Id.* (These large withdrawals created liquidity problems for the thrift, since usually only a relatively small amount of currency is kept on hand at any one time.); Nash, *Fed Lending to Savings Units*, N.Y. Times., May 14, 1985, at D5, col. 1. To combat this liquidity problem, these thrifts borrowed large amounts of cash from the Federal Reserve Discount Window, pursuant to a banking law even though the thrifts were not members of the Federal Reserve System. *Id.* The discount window dispenses short-term loans at below-market rates of interest to financial institutions which may be short of ready cash. *Id. See* Berg, *Maryland Enacts Laws on Thrifts Units' Crisis*, N.Y. Times, May 18, 1985, at A35, col. 1, A38, col. 5. On May 8, Maryland's 20 largest thrifts borrowed $119 million from the Federal Discount Window. *Id.* By May 15, the amount borrowed soared to $413 million. *Id.* On May 8, the daily outflow of cash from these 20 thrifts was only $5 million. *Id.* By May 15, the daily outflow skyrocketed to $200 million. *Id. See also* Dreyfus, *supra* note 161, at 58 (Since the MSSIC fund is privately owned, neither the state nor the federal government has an obligation to bailout this non-federal insurance fund if it runs short of cash.).

169. Berg, *supra* note 165, at A1, col. 1. The executive order had no effect on any of Maryland's federally insured banks and S & Ls.

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provided broad authority for the governor to manage the S & L crisis, terminate the private insurance fund, MSSIC, and create the State of Maryland Deposit Insurance Fund Corporation (SMDIFC).[171] The state also authorized $100 million in bonds to insure all deposits up to $100,000 while the thrifts moved into the federal system.[172] The emergency legislation called for a three-phase timetable for obtaining federal insurance: those thrifts with more than $40 million in assets had until December 31, 1985; thrifts with between $15 and $40 million in assets had until December 31, 1987; and thrifts with less than $15 million in assets had until December 31, 1989.[173] To help the thrifts meet the federally required five percent net worth ratio,[174] the Maryland General Assembly enacted legislation creating net worth certificates which would enable SMDIFC to purchase an interest in the thrifts in return for an infusion of SMDIFC money into the thrifts.[175] On May 21, the governor issued a second executive order exempting many inconvenienced depositors from the $1000 a month limitation.[176]

Several months passed and it seemed as if the S & L crisis had subsided in Maryland. Not so. On August 17, 1985, depositors at the Bethesda-based Community Savings and Loan Inc. scrambled for their savings when it was disclosed that Equity Programs Investment Corporation (EPIC), a real estate subsidiary of Community Savings and Loan, was in financial trouble, having failed to make principal and interest payments on over $1 billion in mortgages that it had issued.[177] After a three-day run, the governor ordered a twenty-day halt on all withdrawals from Community Savings and Loan, Maryland's fourth largest S & L.[178] The following day, Community Savings and Loan closed its nine offices for a two-day cooling off period.[179]

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171. MD. FIN. INST. CODE ANN. § 10-102 (Supp. 1986).

172. Act of May 18, 1985, chap. 4, 1985 Md. Laws ____.

173. MD. FIN. INST. CODE ANN. §§ 10-117 to -118 (Supp. 1986). As to the state, getting the thrifts into the federal system means that it no longer has to guarantee the deposits. *Id.* As to depositors, it means full access to their funds. *Id.*

174. *Id.* at § 9-324.

175. *Id.* at § 9-224.

176. *Curbs Ease in Maryland*, N.Y. Times, May 22, 1985, at D4, col. 4. Under the new order, depositors may exceed the $1000 limitation to pay school tuition bills, residential mortgage installments, institutional, custodial, or medical care of a person over 65 years of age, or consummating a real estate property settlement.

177. Purdum, *Run on Maryland Thrift Unit*, N.Y. Times, Aug. 19, 1985, at D1, col. 6; *Maryland Thrift Unit Closing for Two Days*, N.Y. Times, Aug. 21, 1985, at D8, col. 5 (EPIC was late with approximately $15 million in interest premiums.).

178. Berg, *Maryland Thrift Unit Moratorium*, N.Y. Times, Aug. 20, 1985, at D1, col. 3; Nash, *U.S. Moves to Aid Maryland Thrift Units*, N.Y. Times, May 15, 1985, at D19, col. 5 (Old Court was the second largest S & L in the state, whereas Merritt Commonwealth Saving and Loan was the ninth.).

179. *Maryland Thrift Unit Closing for Two Days*, *supra* note 177.

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Less than a week later, the governor imposed a sixty-day ban on most withdrawals on First Maryland Savings and Loan, Maryland's eighth largest thrift, after the thrift disclosed that it had liquidity problems.[180] To date, Maryland is still sorting out its banking mess.

A. *The Causes*

1. Poor Management and Lack of Supervision

In Mississippi, the Bankers Trust's collapse was attributed principally to poor management and lack of adequate supervision.[181] Management at Bankers Trust frequently made large, commercial real-estate loans without first ascertaining the fair market value of the property.[182] Along the same line, Bankers Trust approved loans for amounts far greater than the fair market value of the property which secured the loans.[183] The S & L also committed numerous banking infractions and violated two state banking laws.[184] Two of the numerous minor infractions included the failure to preserve certain documents in the files[185] and failure to maintain adequate reserves pursuant to state regulations.[186] Bankers Trust's first violation of a state banking law arose from the purchase of an ailing thrift institution.[187] Another state law violation arose when Bankers Trust made illegal investments.[188] Thus, poor management compounded by a lack of state regulation led to Bankers Trust's downfall.[189]

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180. Wiggins, *Another Thrift Freezes in Maryland*, N.Y. Times, Aug. 24, 1985, at A31, col. 3 (First Maryland Savings and Loan has assets of approximately $443 million.). *See* Sullam, *Silver Springs S & L Funds on 60-Day Hold*, Sun (Baltimore, Md.), Aug. 24, 1985 (available on NEWSBANK, INC., Microfiche No. BUS 91:C13) (The ban on withdrawals was needed so that First Maryland Savings and Loan would have enough reserves to qualify for federal deposit insurance, since depositors had withdrawn $8.9 million since the beginning of the month.).

181. Zeller, *Loan by S & L Questioned in Testimony*, Clarion Ledger (Jackson, Miss.), Sept. 21, 1976 (available on NEWSBANK, INC., Microfiche No. BUS 32:B4) (Failure to obtain appraisals prior to the granting of a loan constitutes unsafe and unsound banking practices.).

182. Bankers Trust granted a Canton firm a loan for a cold storage warehouse without first obtaining approval. A notation on the loan stated: "Get approval." *Id.*

183. For example, Bankers Trust once loaned $691,725 secured by a parcel of property with an appraised value of only $491,000. *Id.*

184. Zeller, *S & L Probe Uncovered Violations*, Clarion Ledger (Jackson, Miss.), Sept. 21, 1976 (available on NEWSBANK, INC., Microfiche No. BUS 32:B7–8).

185. The missing documents included fire insurance policies, original deeds of trust, closing documents, and appraisals. *Id.* at BUS 32:B8.

186. In June 1975, Bankers Trust's net worth reserve was 3.3% of its total withdrawable savings accounts, whereas state law requires a net worth reserve of 5%. *Id.*

187. *Id.* at BUS 32:B7.

188. Bankers Trust illegally invested in Tennessee natural gas bonds and illegally purchased stock in a company owned by Liberty Saving and Loan. *Id.* at BUS 32:B8.

189. State examiners compiled a four-page list of problems at Bankers Trust approximately a full year before its collapse. *Id.* at BUS 32:B7–8. Yet state regulators failed to act. *Id.* A report also stated that management at Bankers Trust was lax. *Id.*

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Similar factors led to the downfall at Commonwealth Savings Company in Nebraska. However, Commonwealth's financial woes can be traced directly to the management practices of its prominent owner, S.E. Copple.[190] During the real estate boom of the 1970's, Commonwealth lent to many home builders who were not firmly established and who had little or no net worth.[191] For example, builders would purchase property with no downpayment[192] and would proceed to construct a house.[193] If a builder sold a house and lacked money to repay the loan, Commonwealth would extend further credit in the hope that the builder would break even on subsequent constructions. For several years, Commonwealth profited handsomely. Most of the property purchased by these so-called builders was originally owned by Commonwealth's president or his immediate family,[194] and Commonwealth charged high rates of interest to the builders. In 1980, the housing market collapsed and the builders left town.[195] Commonwealth was left holding only secured real estate, a nonliquid and nonearning asset.[196]

Another flaw with Commonwealth's management was the failure to spread risk adequately.[197] A 1983 investigation revealed that ninety borrowers accounted for approximately 80% of Commonwealth's total outstanding loans.[198] In addition, most of these loans approached Commonwealth's single borrower's limit.[199]

A large volume of classified or substandard loans also plagued Commonwealth's financial health.[200] State banking officials knew as early as 1978 that the institution's stability was deteriorating, but they failed to act.[201] Commonwealth's lending practices continued to gener-

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190. Kotok, *Special Attorney: $32 Million Lent, No Down*, Omaha World Herald, Dec. 4, 1983 (available on NEWSBANK, INC., Microfiche No. BUS 132:C8).

191. Commonwealth financed so-called carpenters, anyone "with $500, a tool box and a pickup." *Id.* Just about anyone could qualify for a Commonwealth loan. *Id.*

192. In effect, Commonwealth would finance 100% of the purchase price. *Id.* In 1983, Commonwealth's outstanding no-downpayment loans amounted to more than $32 million. *Id.*

193. Builders who obtained their loans from Commonwealth were known as "S.E. boys," since S.E. Copple, the president of Commonwealth, readily granted a loan to anyone who called himself a builder. *Id.*

194. *Id.*

195. *Id.*

196. Dorr, *Inside Data Perhaps Led to Savings Withdrawl*, Omaha World Herald, Dec. 10, 1983 (available on NEWSBANK, INC., Microfiche No. BUS 132:C1-2) (In fact by 1983, Commonwealth had barely 28.4% of its total assets earning a monetary return.).

197. *See supra* note 190 and accompanying text.

198. *Id.*

199. *Id.*

200. *See supra* note 196 (A classified loan is one that state banking regulators consider to be uncollectible.).

201. In 1978, classified loans—substandard, doubtful, or losses—amounted to $9.6 million. By 1979, they increased to $10.5 million. *Id.*

ate paper profits "without real or meaningful profitability."[202] By 1983, Commonwealth's depositors were in jeopardy. The S & L had violated numerous banking laws by giving strawman loans,[203] excessively concentrating credit, and granting loans without prior approval of the board of directors.[204]

Yet another cause of Commonwealth's downfall was lack of an adequate insurance premium.[205] In April 1980, the Director of the State Banking and Finance Department permitted insurance on deposits covered by NDIGC, the private fund, to be increased from $10,000 to $30,000 without any corresponding increase in insurance premiums.[206] As with Bankers Trust, the causes of Commonwealth's collapse emanated from two sources: lax management and inadequate supervision.

As in other state crises, the major factor contributing to Maryland's S & L debacle was mismanagement of funds at Old Court.[207] At the outset, Old Court grew at a tremendous rate. Under the leadership of its owners,[208] Old Court grew from $140 million in assets to $873 million in assets in just three years to the second largest S & L in Maryland.[209] To achieve this rapid growth, Old Court frequently offered depositors some of the highest rates of interest in the nation.[210] In order to pay these higher interest rates, Old Court had to and did make riskier and more speculative investments, sinking more than 70% of its deposits in commercial loans, construction loans, and unimproved land loans, well in excess of the 40% limit stipulated by the MSSIC, Maryland's private insurance fund.[211]

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202. *Id.*

203. *See supra* note 190 and accompanying text.

204. *See supra* note 196 and accompanying text (Substantial, doubtful, and loss loans increased from $9.6 million in 1978 to a staggering $54 million in 1983.).

205. *Id.*

206. In effect, the risk covered by the private fund tripled, while the premiums paid to NDIGC remained the same. *Id.*

207. Salpukas, *Allegations Against Old Court*, N.Y. Times, May 16, 1985, at D8, col. 6 (Glass & Associates, Old Court's internal auditors, stated that this thrift's management was not "adequate to control the operation effectively.").

208. Old Court has three owners: Jeffrey Levitt, the president, is a real estate executive who owns 41%; Allen Pearlstein, a shoe manufacturer, owns 41%; and Jerome Cardin, a lawyer, owns the remaining 18%. *Id.*

209. Klott, *Old Court: Fast Growth, but High Risk-Taking*, N.Y. Times, May 20, 1985, at D1, col. 1 (Jeffrey Levitt was considered a maverick when it came time to investing money, but not someone who usually made risk-free loans.).

210. *Id. See also How Old Court Rates Compare*, Sun (Baltimore, Md.), May 11, 1985 (available on NEWSBANK, INC., Microfiche No. BUS 54:C10) (At times, Old Court offered three percentage points higher than the national average on money market certificates.).

211. Klott, *supra* note 209, at D5, col. 3; Sullam, *Problems at Old Court Noted by MSSIC in Feb.*, Sun (Baltimore, Md.), May 14, 1985 (available on NEWSBANK, INC., Microfiche No. BUS 54:D7-8). Old Court had 19% in residential construction loans; 13% in commercial construction

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Old Court also had liquidity problems. Its ratio of net worth to assets constantly fell below the minimum ratio required by MSSIC.[212] To increase its net worth ratio, Old Court significantly overvalued its assets, prompting the thrift's own accountant to refuse to sign a statistical report.[213]

Old Court had problems with composition of its loan portfolio,[214] a critical factor in determining if a thrift can operate profitably. Old Court's portfolio was not liquid, and it faced approximately $200 million in maturing certificates of deposit due within ninety days.[215]

In addition to poor management, insider transactions and violation of conflict of interest laws also plagued Old Court. The Attorney General of Maryland accused several of the directors, officers, and their families of taking part in insider transactions, including the signing of $5.7 million worth of overdrafts.[216] The state also accused the directors and officers of failing to notify MSSIC that they had refinanced $1 million in unsecured, delinquent loans in violation of state law.[217]

Old Court's problems did not arise suddenly. State banking regulators notified MSSIC that the thrift was operationally weak a full year before its collapse.[218] This evaluation was nothing new to MSSIC, since MSSIC had cited Old Court numerous times as a " 'habitual violator' of MSSIC's regulations."[219] A public opinion poll showed that approximately a third of the people questioned believed that MSSIC was chiefly responsible for the S & L crisis, and more than half believed that Old Court's management significantly contributed to the collapse.[220] Curiously enough, 43% of the people polled said the financial situation was so unstable that the S & L crisis was inevitable, while

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loans; 23% in commercial loans; and 22% in land development loans. *Id.* Only 22% of Old Court's portfolio was loaned to owner-occupied residences, whereas the industry norm was 70%. *Id.* Owner-occupied residential mortgages are considered to be stable and dependable sources for revenues. *Id.* Although commercial loans carry a greater rate of return, they are also much riskier than residential mortgage loans. *Id.* at BUS 54:D8. Old Court also exceeded MSSIC's ceiling of 25% on commercial loans by regularly maintaining a 28.7% ratio. *Id.*

212. Old Court's ratio of 3.19% was below the stipulated 4.66% required by MSSIC. *Id.*

213. *Id.*

214. *Id.*

215. *Id.*

216. Salpukas, *supra* note 207 (In effect, these overdrafts were unsecured, interest-free loans, violating a conflict of interest provisions.). *See* Eklund, *The Deals Old Court Has Left Undone*, Bus. Week, June 3, 1985, at 39, 40 (There were 20 unsecured loans amounting to $5.8 million.).

217. Salpukas, *supra* note 207.

218. Sullam, *Old Court Cited for Rule Violation in May of '84, MSSIC Minutes Show*, Sun (Baltimore, Md.), July 17, 1985 (available on NewsBank, Inc., Microfiche No. BUS 80:G5).

219. *Id.*

220. Frece, *Md.-Chartered S & Ls Still Distrusted*, Sun (Baltimore, Md.), June 23, 1985 (available on NewsBank, Inc., Microfiche No. BUS 67:E13).

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35% of the people stated that the local media caused the crisis.[221]

2. High Interest Rates and Deregulation

A savings and loan association which is not federally insured is not subject to federal regulations.[222] Therefore, since privately insured S & L associations are not subject to the federal interest rate ceiling, these S & Ls can offer higher interest rates and thereby attract more depositors. For a while, the thrift industry prospered.[223] Then came the high interest rates of the late 1970's and early 1980's which nearly buried the S & L industry.[224] The losses were staggering. The reason was simple: S & Ls make money on the difference between the interest they pay depositors and the interest they earn from borrowers. However, amid the skyrocketing interest rates of the 1980's, this formula got scrambled.[225] Since the thrifts were saddled with thirty-year fixed-rate home mortgages yielding less interest than the thrifts were having to pay for deposits, out-going cash exceeded in-coming cash and the S & L industry took a beating.[226] During 1978 to 1983, one thousand thrifts folded, nearly one-fourth of the industry in 1978.[227] For this reason, many thrifts shifted to variable rate mortgages whose yield rises and falls with the interest rate.[228]

Then came deregulation. To enable thrifts to better adjust to violatile interest rates, Congress enacted the Depository Institutions Deregulation & Monetary Control Act of 1980 (DIDMCA)[229] and the Garn-St. Germain Depository Institution Act of 1982.[230] These two major pieces of legislation allow thrifts to be more competitive with banks by

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221. *Id.*

222. *See* Medley, *supra* note 144, at 11.

223. Satterfield, *The New S & L Struggling to Survive*, Miami Herald, June 10, 1985 (available on NewsBank, Inc., Microfiche No. BUS 67:B7–8). Since 1933, the main function of a S & L has been to provide financing for homeowners. *Id.* Congress permitted S & Ls to offer a quarter of a percentage point higher for deposits than a bank could legally offer. *Id.* Subsequently, the "spread" widened to two percentage points. *Id.* By paying only 5% for deposits and lending this money to homeowners at 7%, the thrift industry prospered. *Id.* at BUS 67:B8.

224. *Id. See* Koepp, *Another Time Bomb Goes Off*, Time, May 27, 1985, at 56, 56–58 (During this period, the prime rate hit an all time high of 20.5%.).

225. *See* Satterfield, *supra* note 223, at BUS 67:B8.

226. *Id.*

227. Burkhardt, *Capital Adequacy Continues to Haunt the S & L Industry*, San Diego Union, Dec. 15, 1985 (available on NewsBank, Inc., Microfiche No. BUS 133:F5). *See* Johnson, *Industry Recovery Easing Strain on FSLIC*, Sun (Baltimore, Md.), May 19, 1985 (available on NewsBank, Inc., Microfiche No. BUS 54:C4) (The S & L industry lost approximately $10 billion during 1981–82.).

228. Koepp, *supra* note 224, at 56–58.

229. Pub. L. No. 96-221, 94 Stat. 132 (currently codified in scattered sections of title 12 of the U.S.C.).

230. Publ. L. No. 97-320, 96 Stat. 1469 (currently codified in scattered sections of titles 11,

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broadening the thrifts' power to attract and keep depositors.[231]

Deregulation has broken the barriers which have traditionally separated thrifts from commercial banks.[232] With their new powers, thrifts are able to compete more aggressively for deposits from other financial institutions. As a result, thrifts no longer need to invest solely in long-term fixed-rate mortgages. They may now diversify their lending activity.[233]

As a result of deregulation, thrifts have prospered.[234] Some termed this expansion as "reckless growth," as many S & Ls doubled their assets and outstanding loans in 1984.[235] To accomplish such a feat, thrifts often made speculative and risky investments, sinking depositors' funds into such ventures as restaurants, thoroughbred horses, and oil explorations.[236] The whole thrift industry partook in these often lucrative, always risky, ventures—privately and federally insured thrifts alike.[237] Unfortunately, this rapid growth was costly. To privately insured thrifts, it meant bank runs and bank holidays. To federally insured thrifts, it meant mergers and bailouts. To these federally insured thrifts, the FSLIC had to make many expensive rescues.[238] Its reserves shrank more in 1984, due to bailouts, than in any previous year to a historical low of 0.76% of total deposits.[239] The side effect of deregulation—irresponsible growth—has prompted calls for reform and a closer look at the S & L industry.

Chairman of the House Banking Committee, Fernand St. German, believes that deregulation of financial institutions has led to the recent banking and S & L association troubles.[240] He perceives deregulation as causing a chain reaction. Eliminating the ceiling on interest rates which a financial institution can pay depositors causes increased competition. Increased competition forces financial institutions to offer higher rates of interest for deposits. Higher interest rates force financial institutions to make riskier investments in order to pay higher rates to depositors. And riskier investments lead to bank failures.[241]

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231. FEDERAL HOME LOAN BANK BOARD, AGENDA FOR REFORM 37–40 (1983).

232. *Id.* at 39.

233. *Id.*

234. *See* Riemer, *Washington Wrangles as the Thrift Crisis Deepens*, BUS. WEEK, May 27, 1985, at 128, 129 ("In 1984, the thrift industry grew by 20% . . . .").

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.*

239. Dreyfus, *supra* note 161, at 57.

240. Koepp, *supra* note 162, at 57.

241. *Id. See* Wenzel, *Deregulation of Financial World Takes Another Step on Oct. 1*, Milwaukee J., Sept. 18, 1983 (available on NEWSBANK, INC., Microfiche No. BUS 95:G5) (As of 1985, three-fourths of total bank deposits were not regulated.).

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B. *The Solutions*

1. Private versus Federal Insurance: Pros and Cons

The stability of any financial institution, whether it be privately or federally insured, is based not upon a bank's assets or capital but rather upon the confidence of its depositors.[242] With the past and recent crises in the S & L industry, a new awareness has unfolded concerning the security of privately insured funds as compared with those which are federally insured.[243] Typically, banks or S & Ls are either federally chartered or state chartered.[244] If a bank is federally chartered, it is required to be a member of the FDIC.[245] If a S & L is federally

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242. *See* Mahoney, *U.S. Must Strain to Protect Thrift Depositors*, Cleveland Plain Dealer, June 24, 1985 (available on NEWSBANK, INC., Microfiche No. BUS 67:C14, at D2).

243. *See* E. COX, BANKERS DESK REFERENCE (1984). While privately insured institutions may experience bank runs, federally insured ones do not.

> The FDIC was designed to prevent destabilizing runs on banks. Before establishment of the FDIC, it was possible for a sound financial institution to suffer a sudden withdrawal of deposits in response to rumors or doubts about its financial condition. This could result from the failure of a nearby or related institution coupled with the nature of the costs and benefits of participating in a run.

Id. at 81.

Once rumors of financial instability begin to circulate, it is not unreasonable for depositors caught in the panic to make a run on a particular bank.

> It costs very little to withdraw funds from a bank on the basis of a rumor that turns out to be false; on the other hand, the cost of not withdrawing funds quickly, if the bank is truly about to fail, is very large. Even the depositor who knows that the bank is sound has an incentive to get his funds out before the actions of other depositors bring down the bank. Given this asymmetry in the costs and benefits, participating in a run is not irrational behavior.

Id.

244. E. BARNETT, RESPONSIBILITIES AND LIABILITIES OF BANK AND BANK HOLDING COMPANY DIRECTORS (1985). The concept of a dual banking system stems from the fact that banks are chartered and regulated by different agencies.

> Banks chartered by states are divided into those which have become members of the Federal Reserve System and those which have not.* State member banks are regulated and supervised in the first instance by state governments, usually through a state department known as the Banking Department. At the federal level, those banks are regulated and supervised by the Board of Governors of the Federal Reserve System and are required to have FIDC [sic] insurance. State non-member banks are likewise regulated and supervised in the first instance by state governments, but at the federal level are regulated and supervised by the Federal Deposit Insurance Corporation.** Banks that are chartered by the federal government, "national banks," receive their charter, regulation and supervision from the Office of the Comptroller of the Currency, although they are required to be Federal Reserve member banks and to be FDIC insured.
>
> *Those who have opted for Federal Reserve membership are known as "state member banks" and those who have not opted for Federal Reserve membership are known as "state non-member banks."
>
> **Assuming, as is almost always the case, that the state non-member banks' deposits are insured by the FDIC.

Id. at 9.

245. *Id.*

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chartered, it is required to be a member of the FSLIC.[246] These two federal agencies insure deposits up to $100,000 per account, and their guarantee of safety is the best available by any financial institution.[247] In several states, S & Ls that receive their charters from state governments have the option of signing up for federal insurance or private insurance.[248] However, out of the six states which permitted private insurance fund as of March 1985, two states now specifically prohibit such funds.[249] In three other states, members of the private fund have voluntarily applied for federal insurance due to the recent S & L problems.[250]

S & Ls converting from private insurance to federal insurance may face a difficult, if not an impossible, task. Eligibility requirements for federal deposit insurance are more stringent than private deposit insurance.[251] For instance, to qualify for federal insurance, an S & L must have capital equal to at least 5% of its insured deposits, meet a three year viability test, be open at least five days a week, have a street level office, and have total assets of at least $3 million.[252]

Private and federal insurance each have advantages and disadvantages. First, limits on interest rates that each could offer differed. Prior to 1980, privately insured S & Ls had a significant advantage over federally insured S & Ls in that federally insured institutions, being subject to federal laws, were prohibited from offering interest rates in excess of 5.5% for deposits on passbook accounts.[253] Privately insured

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246. *Id.*

247. Dreyfus, *supra* note 161, at 57. Federal insurance is regarded as the bedrock of public confidence.

248. Reiff, *Depositors Suddenly Aware of Banking Safety*, Akron Beacon J., May 19, 1985 (available on NEWSBANK, INC., Microfiche No. BUS 67:D14–E1) (As of March 1985, six states nationwide—Georgia, Maryland, Massachusetts, North Carolina, Ohio, and Pennsylvania—permitted their S & Ls to carry private insurance.).

249. Both Ohio and Maryland legislatively require S & Ls within the state to also maintain federal insurance. Ohio amended Sub. Sen. Bill No. 119; MD. FIN. INST. CODE ANN. § 10-102 (Supp. 1986). Both Ohio's and Maryland's legislators passed these bills in response to the S & L crisis within their state.

250. Kristof, *Private Insurance in Spotlight*, N.Y. Times, May 15, 1985, at D19, col. 1; Reiff, *supra* note 248, at BUS 67:E1. All 67 members of North Carolina's private insurance fund, Financial Institutions Assurance Corporation, unanimously agreed to apply for federal insurance. *Id.* In Massachusetts, a majority of the members of Mutual Savings Central Fund, Massachusetts' private fund, quietly obtained federal insurance. *Id.* In Georgia, 10 members of the Georgia Deposit Insurance Corporation voluntarily applied for federal insurance. *Id.*

251. Nash, *Federal Insurance Stricter than Private Systems'*, N.Y. Times, May 16, 1985, at D9, col. 1.

252. The S & L will meet the viability test if for three years its capital does not shrink below 3% of its insured deposits. *Id.* Additionally, the S & L only needs assets of $2 million if it does business in a rural area. *Id.*

253. *Id.*

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institutions, not subject to federal law, had no such limit.[254] Second, investment opportunities are far greater for privately insured institutions than for federally insured ones, thereby permitting privately insured members an opportunity to reap a greater profit. For instance, federal regulators prohibit real estate investment from exceeding 10% of an institution's total assets, whereas this limit does not apply to privately insured institutions.[255] Third, under federal law the Community Reinvestment Act prohibits "redlining"—the granting of loans in disproportionate percentages according to race or wealth of the clients.[256] Since privately insured institutions are not bound by federal law, they may grant loans to whomever they please. Finally, despite the burdensome requirements of federal insurance, a major attraction to it still exists—the safety and security of its fund.[257] While state and federal governments are not obligated to bailout a failing private insurance fund, the United States Treasury stands behind the FDIC and the FSLIC. This backing means that each federal insurance fund has a confirmed credit line with the United States Treasury should either fund be depleted.[258]

Conservatives maintain that the private insurance funds in Ohio and Maryland were not put to a fair test, arguing that these funds were not permitted to spread the risk outside their borders and throughout the nation.[259] Defenders of the private funds also assert that these funds are more efficient[260] because the private sector is always more cost conscientious. Proponents of the private funds also allege that these funds are stronger than the federal funds and have more cash to pay claims than the federal funds.[261] However, critics of the private

254. Medley, *supra* note 144, at 11.

255. Nash, *supra* note 251.

256. *Id.*

257. Dreyfus, *supra* note 161, at 57–58.

258. The FDIC has an approved credit line of $3 billion, and the FSLIC, $750 million. *Id.* Johnson, *supra* note 227. Technically, the FDIC and FSLIC do not have the full faith and backing of the federal government. No federal law exists which would require the United States Treasury to bailout either fund; currently, only a joint resolution of Congress exists for such an emergency bailout. *Id.*

259. Tolchin, *Private Insurance for Banks Debated*, N.Y. Times, June 11, 1985, at D15, col. 2. The Reagan Administration is steadfast in its beliefs of privatization—the notion that the private sector can accomplish anything that the federal government can do more efficiently and effectively. *Id.* The sole exception is in regard to the military. *Id.*

260. A White House official claimed, "The free market provides a better system than the federal Government. You have a lot of S. & L.'s making fairly good investment decisions that the Feds probably wouldn't have made." *Id.*

261. Cohen & Ibata, *Will Ohio Debacle Spell End of Privately Insured S & Ls?*, Chicago Tribune, Mar. 27, 1985 (available on NewsBank, Inc., Microfiche No. BUS 27:E11–12) (Defenders of private insurance stress that what happened in Ohio was due to faulty regulation.). *See* *Supra* note 11. Ironically, most private funds have greater reserve to total deposits ratios than

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insurance funds point out that public confidence in any financial institution can be achieved only by federal insurance, since the FDIC or the FSLIC can always turn to the United States Treasury for ready cash.[262] It should also be noted that the United States has insured deposits for only fifty years and is the only nation that does so. Even the ultra-conservative Swiss simply fail to provide any deposit insurance at all to their banking customers.[263]

2. Survival of the Private Insurance Fund

Many factors are responsible for the success or failure of a private insurance fund. First, the quality of the regulatory supervision of a private insurance fund is of utmost importance to the fund's stability and success.[264] Several critics of the private insurance fund maintain that poor supervision was the main cause of Ohio's and Maryland's banking troubles.[265] They assert that in each instance state banking regulators had been keenly aware of each institution's financial instability for a year or more, yet the regulators failed to act. A Massachusetts banking official commented on the Ohio debacle: "The Ohio problem was not an insurance problem. It was a regulatory problem that became an insurance problem because of the regulators' failure to act."[266] In 1983, Ohio's regulators knew that half of Home State's liabilities were invested in risky repurchase agreements. If regulators had prohibited Home State from trading in the repurchase agreements, losses could have been cut to $10 million.[267] One critic of private insurance funds alleges that federal regulators are more adept at spotting problem banks before they collapse than state regulators.[268] It is asserted that state regulators may fail to intervene because they lack financial incentives to act or because political motives force them to remain silent. While private insurance funds have an interest in correcting the problem, many such funds lack the regulatory power to do so.[269] Therefore, it appears that for a private insurance fund to be successful, there must be competent, experienced supervision.

Second, the liquidity of and access to an outside line of credit are other factors which determine the success or failure of a private insur-

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either the FDIC or the FSLIC. *Id.* Ohio's ratio was 3% and Maryland's 2.6%, whereas the FSLIC's ratio is 0.7% and the FDIC's ratio is 1.3%. *Id.*

262. *See supra* note 259 and accompanying text.

263. *Id.*

264. Linnen, *supra* note 39, at 56.

265. *Id.*

266. *Id.*

267. *Id.*

268. Medley, *supra* note 144, at 12.

269. *Id.*

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ance fund.[270] In fact, when depositors scrambled for their savings in Ohio, ODGF, the private fund, lacked any kind of an emergency line of credit. Faced with massive withdrawals of cash, most Ohio S & Ls had nowhere to turn for ready cash to sustain such large withdrawals. Many S & Ls turned to the Federal Reserve Window, where none of the S & Ls had previously filed for access.[271] In contrast to Ohio's private fund and lack of a line of credit, Massachusetts' private fund maintains a $60 million line of credit with several commercial institutions.[272] Several of these S & Ls also maintain individual lines of credit, and just under half of Massachusetts' S & Ls are members of the Federal Home Loan Banking Board which provides an additional source of emergency credit.[273] All other private insurance funds except those in Pennsylvania have an emergency line of credit with commercial banks in the federal reserve. Maintaining a line of credit is no guarantee of success. Even with an emergency line of credit intact, a bank run still might occur.

Third, the financial health of a private insurance fund may be judged by the adequacy of the fund.[274] Ohio's private fund, ODGF, was praised for having a "sizable fund,"[275] yet the $136 million fund proved inadequate to instill much confidence in Ohioans when it quickly disappeared. One commentator noted the inherent inadequacy of private insurance funds: "No private fund has enough money to cover even four percent of the deposits they insure. In essence, these funds are not offering insurance, they're offering a lottery for depositors willing to bet there will be no major trouble."[276] Private funds simply lack adequate reserves. The potential for losses is staggering. As illustrated in Ohio and Maryland, when one S & L becomes unstable, public confidence weakens. In turn, depositors are quick to withdraw their savings from perfectly stable institutions, thereby creating liquidity problems and making them unstable. "The magnitude of potential losses from a wave of bank or thrift failures is beyond the capacity of the private insurance industry to underwrite on its own."[277]

Fourth, diversification of investments is a key factor in judging the viability of a private insurance fund.[278] As membership in a private insurance fund increases, the chance of failure of any one member de-

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270. Linnen, *supra* note 39, at 57.
271. *Id.*
272. *Id.*
273. *Id.*
274. *Id.*
275. *Id.*
276. Medley, *supra* note 144, at 12.
277. *Id.*
278. Linnen, *supra* note 39, at 57.

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creases. The extremes tend to balance one another.[279] Defenders of the private insurance fund believe that the capability of these funds was not put to a fair test.[280] They argue that a greater diversification of investments by these private insurers across state lines would have better insulated them and their depositors from substantial cash outflows. Membership in the fund would increase, thereby decreasing the risk to any one member. Since state law in Ohio and Maryland specifically prohibits such investments across state borders,[281] investments are not diversified and risk becomes higher.[282]

Finally, all financial institutions should devise a crisis plan in the event a possible bank run develops.[283] Such a plan should include monitoring of press reports.[284] If a crisis does hit, a financial institution should be frank with the press, not evasive. Management of the financial institution should be alerted and should be briefed on what to and what not to say. A question and answer sheet, listing strengths of the financial institution, should be given to the employees to give to the customers or the media. While these techniques may not always quell a bank run, they could serve to restore confidence in the depositor.

V. Conclusion

There was a time when that reassuring phrase—money in the bank—meant something, instilling a sense of trust and confidence in the depositor. However, in the wake of past and present disasters that have shaken the nation's banks and S & Ls in the past few years, that time-honored phrase has a hollow ring. Depositors now may doubt the strength of their financial institution.

The stability of any banking institution is based on the confidence of the depositors. When a depositor is confident that his savings are secure, banking institutions function smoothly. However, when a depositor loses faith in the stability of the bank, the depositor will quite naturally and undoubtedly withdraw his savings, since it cost little to do so as compared to the losses that he could sustain if the bank goes under. If enough depositors become concerned and momentum gathers, such an event is known as a bank run—a long and sustained demand for cash.

Little risk exists if the financial institution is federally insured,

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279. Federal Home Loan Bank Board, *supra* note 231, at 104.

280. *See supra* note 259 and accompanying text.

281. *Id.*

282. *Id.*

283. Gist, *A Plan in the Firs: Step to Handling a Crisis Effectively*, Savings Institutions, May 1985, at 62, 65.

284. *Id.*

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since it is readily believed that the federal government would step in and bailout the FDIC or the FSLIC if either fund were to run short of reserves. Conversely, much risk exists if the institution is privately insured. The security of deposits at these institutions is questionable at best. Problems with private insurance funds include: lax regulatory supervision, lack of liquidity, inadequacy of the fund, and inability to diversify investments. The Ohio debacle, prompted by the failure of ESM, was due in large part to the susceptibility of private insurance funds to such factors. Fortunately, Ohio's governor and legislature were wise enough to recognize the problem and then acted promptly and decisively. By working together, the governor and legislature made the transition from private insurance to federal insurance by S & Ls a smooth one. Overall, through the persistence and diligence of each, the Ohio bank crisis was brought to a workable conclusion.

Nothing that has happened to the privately insured S & L industry has placed federally insured deposits at risk. When bank runs recently occurred at privately insured institutions, depositors in nearby federally insured institutions were sophisticated enough to understand that their deposits were safe. Hence, no bank runs occurred at these federally insured thrifts.

The prudent course would be for Congress to set a timetable for ending private deposit insurance funds. Congress should insist that privately insured S & Ls and thrifts switch to federal insurance. Even though many federally insured S & Ls are in weak financial condition, at least these institutions have the benefit of Congress' capacity to guarantee their deposits. Such cannot be said for deposits still in private insurance funds.

Lori Ellen Shaw
Jeffrey Begens

S. 113

Code Sections Affected: To amend sections 1151.01 and 1157.11 of the Ohio Revised Code.
Effective Date: March 13, 1985.
Sponsor: Finan (S)
Committee: Financial Institutions and Insurance (S)

S. 143

Code Sections Affected: To enact sections 1155.23 to 1155.31 of the Ohio Revised Code.
Effective Date: April 6, 1985.
Sponsor: Lukens (S)
Committee: Financial Institutions and Insurance (S) Financial Institutions (H)

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