APPENDIX B

The Five-Senators Meeting

THE FIVE-SENATORS MEETING: APRIL 9, 1987

[The following memorandum was prepared by Federal Savings and Loan Insurance Corporation official William "Bill" Black. Black accompanied three San Francisco regulators who had been summoned to Washington, D.C., by five U.S. senators, each of whom had received sizeable campaign contributions from Charles Keating, his company American Continental Corp., its subsidiary Lincoln Savings and Loan, or Keating's employees or associates. The subject of the meeting was to be the San Francisco FHLB's extended examination of Lincoln Savings. Regulators contended Lincoln was exaggerating the value of properties in which it had invested or on which it had made loans.

Black's boss, Federal Home Loan Bank Board chairman Ed Gray, had asked Black to report back to him on the meeting, and he took the notes that formed the basis for this memorandum.]

Edwin J. Gray
Chairman

April 10, 1987

William K. Black
Deputy Director, FSLIC

April 9, 1987 Meeting of
FHLB-SF Personnel with
Senators Cranston, DeConcini,
Glenn, McCain and Riegle

At your request I am providing you this memorandum, which reflects the substance of yesterday's meeting with Senators Cranston, DeConcini, Glenn, McCain and Riegle. The Federal Home Loan Bank of San Francisco (FHLB-SF) personnel who attended the meeting were James Cirona (President and Principal Supervisory Agent), Michael Patriarca (Director of Agency Functions), myself (general counsel) and Richard Sanchez (the Supervisory Agent for Lincoln S&LA of Irvine, Calif.). The meeting commenced at 6:00 P.M. and ended at approximately 8:15 P.M., with two breaks of approximately 15 and 10 minutes during which time the Senators voted. Senator Cranston was present only very briefly, because of his responsibilities on the Senate floor. The other Senators were present for substantially the entire meeting.

This meeting was the product of an earlier meeting among yourself and Senators Cranston, DeConcini, Glenn and McCain. At that meeting, as related by you (and by these same Senators in yesterday's meeting) each of the Senators raised their concerns regarding the examination of Lincoln by the FHLB-SF and you noted your unfamiliarity with any specifics of the examination, your confidence in the FHLB-SF and your suggestion that the Senators hear from the FHLB-SF our supervisory concerns regarding Lincoln.

I was the only one at the April 9 meeting who took notes. While not verbatim, my notes are very extensive. At your request, I called you last night and read these notes to you. I have attached a copy of those notes to this memorandum. I have used these notes and my independent recall of the meeting to prepare this memorandum and provide the fullest possible record of the discussions at yesterday's meeting. I have circulated this memorandum to Messrs. Cirona, Patriarca and Sanchez for their review to ensure the accuracy of this memorandum. I believe that his memorandum is an accurate and complete record of the substance of yesterday's meeting.

CIRONA: I am Jim Cirona. I am president of the Federal Home Loan Bank of San Francisco. I have held that position for four years. I am here in my capacity as principal supervisory agent. We have jurisdiction over California, Arizona and Nevada savings and loans. Before becoming president I was in the industry for 20 years.

DECONCINI: Where?

CIRONA: In New York.

DECONCINI: Did you know Bud Bavasi?

CIRONA: Yes. Bud is a good guy.

DECONCINI: Yes. He's great.

CIRONA: With me is Mike Patriarca, head of our agency function. Mike has joined us recently from the Comptroller of the Currency, where he was in charge of multi-national banks. Before that he was a lawyer for seven years.

MCCAIN: We won't hold that against you.

CIRONA: You were a litigator.

PATRIARCA: No, I was in enforcement for seven years.

CIRONA: Also with me is Bill Black, our general counsel. Bill was formerly director of litigation for the Bank Board for three years. Next to bill is Richard Sanchez. He's been with the San Francisco bank for ____ years. Before that he was an auditor for a commercial bank and before that he was in school.

DECONCINI: Thank you for coming. We wanted to meet with you because we have determined that potential actions of yours could injure a constituent. This is a particular concern to us because Lincoln is willing to take substantial actions to deal with what we understand to be your concerns. Lincoln is prepared to go into a major home loan program—up to 55% of assets. We understand that that's what the Bank Board wants S&Ls to do. It's prepared to limit its high risk bond holdings and real estate investments. It's even willing to phase out of the insurance process if you wish. They need to deal with, one, the effect of your reg . . . Lincoln is a viable organization. It made $49 million last year, even more the year before. They fear falling below 3 percent (net worth) and becoming subject to your regulatory control of the operations of their association. They have two major disagreements with you. First, with regard to direct investments. Second, on your reappraisal. They're suing against your direct investment regulation. I can't make a judgment on the grandfathering issue. We suggest that the lawsuit be accelerated and that you grant them forbearance while the suit is pending. I know something about the appraisal values [Senator Glenn joins the meeting at this point] of the Federal Home Loan Bank Board. They appear to be grossly unfair. I know the particular property here. My family is in real estate. Lincoln is prepared to reach a compromise value with you.

CRANSTON: [He arrives at this point] I'm sorry I can't join you but I have to be on the floor to deal with the bill. I just want to say that I share the concerns of the other Senators on this subject. [Cranston leaves.]

DECONCINI: I'm not on the Banking Committee and I'm not familiar with how all this works. I asked Don Riegle to explain to me how the Federal Home Loan system works because he's on Senate Banking. He explained it to me and that's why he's here.

MCCAIN: Thank you for coming. One of our jobs as elected officials is to help constituents in a proper fashion. ACC is a big employer and important to the local economy. I wouldn't want any special favors for them. It's like the Apache helicopter program that Dennis and I are active on. The Army wants to cut back the program. Arizona contractors make major components of the Apache helicopter. We believe that the Apache is important to our national defense. That's why we met with General Dynamics and tried to keep the program alive.

I don't want any part of our conversation to be improper. We asked chairman Gray about that and he said it wasn't improper to discuss Lincoln. I'd like to mention the appraisal issue. It seems to me, from talking to many folks in Arizona, that there's a problem. Arizona is the second fastest growing state. Land values are skyrocketing. That has to be taken account of in appraisals.

GLENN: I apologize for being late. Lincoln is an Ohio chartered corporation, and . . .

CIRONA: Excuse me. Lincoln is a California chartered S&L.

GLENN: Well, Lincoln is wholly owned by ACC.

DECONCINI: You said Lincoln was Ohio chartered. It's California.

GLENN: Well, in any event, ACC is an Ohio chartered corporation. I've known them for a long time but it wouldn't matter if I didn't. Ordinary exams take maybe up to 6 months. Even the accounting firm says you've taken an unusually adversary view toward Lincoln. To be blunt, you should charge them or get off their backs. If things are bad there, get to them. Their view is that they took a failing business and put it back on its feet. It's now viable and profitable. They took it off the endangered species list. Why has the exam dragged on and on? I asked Gray about his. Lincoln has been told numerous times that the exam is being directed to continue by Washington. Gray said this wasn't true.

RIEGLE: I wasn't present at the earlier meeting. There are things happening that may indicate a pattern that do raise questions [*sic*]. There is broad concern on the Banking Committee about the *American Banker* article on the FADA and FSLIC feud. Gray has great confidence in you as a team. He says you are some of the finest people in the system. The appearance from a distance is that this thing is out of control and has become a struggle between Keating and Gray, two people I gather who have never even met. The appearance is that it's a fight to a death. This discredits everyone if it becomes the perception. If there are fundamental problems at Lincoln, OK.

I've had a lot of people come through the door feeling that they've

been put through a meat grinder. I want professionalism, and your backgrounds attest to that professionalism. But I want not just professionalism, but fairness and the appearance of fairness. So I'm very glad to have this opportunity to hear your side of the story.

GLENN: I'm not trying to get anyone off. If there is wrongdoing I'm on your side. But I don't want any unfairness against a viable entity.

CIRONA: How long do we have to speak to you? A half-hour, an hour?

DECONCINI: As quickly as possible. We have a vote coming up soon.

CIRONA: First, if there's any fault to be had concerning the length of the examination, it's on my shoulders. We determine how examinations are conducted. Gray never gave me instructions on how to conduct this exam or any other exam. At this meeting you'll hear things that Gray doesn't know.

DECONCINI: Did Gray ever talk to you about the examination of Lincoln?

CIRONA: Gray talked to me when that article ran in the Washington *Post*.

PATRIARCA: Gray asked for a written response from us to the Washington *Post* article about the length of the exam at Lincoln. Jim is correct. We received no instructions from Gray about the exam of Lincoln. We decide how to do the exam.

CIRONA: This meeting is very unusual. To discuss a particular company.

DECONCINI: It's very unusual for us to have a company that could be put out of business by its regulators. Richard, you're on; you have 10–12 minutes.

SANCHEZ: An appraisal is an important part of underwriting. It is very important. If you don't do it right you expose yourself to loss. Our 1984 exam showed significant appraisal deficiencies. Mr. Keating promised to correct the problem. Our 1986 exam showed that the problems had not been corrected—that there were huge appraisal problems. There was no meaningful underwriting on most loans. We have independent appraisals. Merrill Lynch appraised the Phoenician [Hotel]. It shows a significant loss. Other loans had similar losses.

DECONCINI: Why not get an independent appraisal?

SANCHEZ: We did.

DECONCINI: No, you hired them. Why not get a truly independent one or use arbitration—if you're trying to bend over backwards to be fair. There's no appeal from your reappraisal. Whatever it is you take it.

SANCHEZ: If it meets our appraisal standards.

CIRONA: The Phoenician reappraisal process is not complete. We have received Lincoln's rebuttal and forwarded it to our independent appraisers.

[At this point the senators left to vote. We resumed when Senators DeConcini and Riegle returned.]

SANCHEZ: Lincoln had underwriting problems with all of their investments, equity securities, debt securities, land loans and direct real estate investments. It had no loan underwriting policy manual in effect when we began our 1986 exam. When the examiners requested such a manual they were informed that it was being printed. The examiners looked at 52 real estate loans that Lincoln had made since the 1984 exam. There were no credit reports on the borrowers in all 52 of the loan files.

DECONCINI: I have trouble with this discussion. Are you saying that their underwriting practices were illegal or just not the best practice?

CIRONA: These underwriting practices violate our regulatory guidelines.

BLACK: They are also an unsafe and unsound practice.

DECONCINI: Those are two very different things.

SANCHEZ: You need credit reports for proper underwriting.

[Senator Glenn returns at this point.]

RIEGLE: To recap what's been said for Senator Glenn: 52 of the 52 loans they looked at had no credit information. Do we have a history of loans to folks with inadequate credit?

SANCHEZ: $47 million in loans were classified by examiners due to lack of adequate credit to assure repayment of the loans.

PATRIARCA: They're flying blind on all of their different loans and investments. That's what you do when you don't underwrite.

GLENN: How long had these loans been on the books?

SANCHEZ: A fairly long time.

GLENN: How many loans have gone belly-up?

SANCHEZ: We don't know at this point how many of the 52 have defaulted. These loans generally have interest reserves.

GLENN: Well, the interest reserves should run out on many of these.

CIRONA: These are longer term investments.

BLACK: I know that Lincoln has refinanced some of these loans.

GLENN: Some people don't do the kind of underwriting you want. Is their judgment good?

PATRIARCA: That approach might be okay if they were doing it with their own money. They aren't; they're using federally insured deposits.

RIEGLE: Where's the smoking gun? Where are the losses?

DECONCINI: What's wrong with this if they're willing to clean up their act?

CIRONA: This is a ticking time bomb.

SANCHEZ: I had another case which reported strong earnings in 1984. It was insolvent in 1985.

RIEGLE: These people saved a failing thrift. ACC is reputed to be highly competent.

BLACK: Lincoln was not a failing thrift when ACC acquired it. It met its net worth requirement. It had returned to profitability before it was acquired. It had one of the lowest rations of scheduled assets in the 11th District, the area under our jurisdiction. Its losses were caused by an interest spread problem from high interest rates. It, as with most other California thrifts, would have become profitable as interest rates fall.

DECONCINI: I don't know how you can't consider it a success story. It lost $24 million in 1982 and 1983. After it was acquired by ACC it made $49 million in one year.

MCCAIN: I haven't gotten an answer to my question about why the exam took so long.

SANCHEZ: It was an extremely complex exam because of their various investments. The examiners were actually in the institution from March to October—8 months. The asset classification procedure is very time consuming.

MCCAIN: What's the longest exam you ever had before?

CIRONA: Some have technically never ended, where we had severe problems with a shop.

MCCAIN: Why would Arthur Young say these things about the exam—that it was inordinately long and bordered on harassment?

GLENN: And Arthur Anderson said they withdrew as Lincoln's prior auditor because of your harassment.

RIEGLE: Have you seen the Arthur Young letter?

CIRONA: No.

RIEGLE: I'd like you to see the letter. It's been sent all over the Senate. [Hands Cirona the letter.]

PATRIARCA: I'm relatively new to the savings and loan industry but I've never seen any bank or S&L that's anything like this. This isn't even close. You can ask any banker and you know about these practices. They violate the law and regulations and common sense.

GLENN: What violates the law?

PATRIARCA: Their direct investments violate the regulation. Then there's the file stuffing. They took undated documents purporting to show underwriting efforts and put them into the files sometimes more than a year after they made the investment.

GLENN: Have you done anything about these violations of law?

PATRIARCA: We're sending a criminal referral to the Department of Justice. Not maybe; we're sending one. This is an extraordinarily serious matter. It involves a whole range of imprudent actions. I can't tell you strongly enough how serious this is. This is not a profitable institution. Prior year adjustments will reduce that reported $49 million profit. They didn't earn $49 million. Let me give you one example. Lincoln sold a loan with recourse and booked a $12 million profit. The purchaser rescinded the sale, but Lincoln left the $12 million profit on its books. Now, I don't care how many accountants they get to say that's right. It's wrong. The only thing we have as regulators is our credibility. We have to preserve it.

DECONCINI: Why would Arthur Young say these things? They have to guard their credibility too. They put the firm's neck out with this letter.

PATRIARCA: They have a client. The $12 million in earnings was not unwound.

DECONCINI: You believe they'd prostitute themselves for a client?

PATRIARCA: Absolutely. It happens all the time.

[The senators left at this point for another vote.]

[We resumed when Senators DeConcini, McCain, and Riegle returned.]

CIRONA: I also wanted to note that the Bank Board has had a lot of problems with Arthur Young, and is thinking of taking disciplinary action against it.

BLACK: Not for its actions here. Primarily because of its Texas office, which has never met a direct investment. They think everything is a loan. This has quite an effect on the income you can claim.

Empire of Texas is a perfect example. It did acquisition, development and construction loans that were really direct investments because the borrowers had no equity in the projects. It booked all the points and fees up front as income. It created interest reserves so the loans couldn't go into default. It provided take out financing and then end loans so that the loans couldn't go into default for many years. All this led it to report record profits. Even when the losses started, as long as it grew fast enough and could book new income up front it could remain "profitable." It gets to be kind of a pyramid scheme with rapid growth. Lincoln has grown very fast.

Many Congressional hearings have been very critical of the Bank Board for not acting more quickly against unsafe and unsound practices. Rep. Dingell our . . . our . . . I grew up in the 16th District. His hearings were very critical about Beverly Hills [Savings], which had a clean accounting opinion, and then, at last count, is over $900 million insolvent.

Then there was Sunrise [Savings], also with a clean opinion and it is expected to cost FSLIC over $500 million. And Congressman Barnard's hearing was very critical there.

CIRONA: Also San Marino.

BLACK: Yes. I can tell you from my experience as former litigation director, where I sued for many of these failed shops, that it is routine for the accounting firm to serve as management's expert witnesses and adopt an extremely adversarial tone.

What it all comes down to is that Congress has been on our ass and many of us think, rightly, to act before an institution fails. That's what we're doing here, and I think it is laudable.

DECONCINI: What?

BLACK: Laudable.

SANCHEZ: Our exam has found that million has [*sic*] to be written off Lincoln's books. That will leave them with a regulatory net worth of $25 million. They will fail to meet their net worth requirement. They have $103 million in goodwill on their books. If this were backed out they would be $78 million insolvent.

PATRIARCA: They would be taken over by the regulators if they were a bank.

DECONCINI: You're saying they're insolvent.

BLACK: They'd be insolvent on a tangible capital basis, which is basically the capital standard for banks.

DECONCINI: They'd be insolvent if they were a bank, but by law you have to use a regulatory capital standard, and under that standard they have $25 million in capital. Is that what you're saying?

PATRIARCA: By regulation we have adopted a regulatory capital standard.

DECONCINI: And you'll take control of them if they fail your net worth standard—you'll take operational control of them.

CIRONA: That's speculative. We'd take steps to reduce their risk exposure.

RIEGLE: What would require them to sell?

CIRONA: We'd probably have them decrease their growth. Time and again we've found rapid growth associated with loss. Lincoln has grown rapidly.

BLACK: Are you sure you want to talk about this? We haven't made any recommendation to the Bank Board yet. The Bank Board decides what action to take. These are very confidential matters.

DECONCINI: No, then we don't want to go into it. We were just asking very hypothetically and that's how you [indicating Mr. Cirona] were responding.

CIRONA: That's right.

DECONCINI: Can we do something other than liquidate them?

CIRONA: I hesitate to tell an association what to do. We're not in control of Lincoln, and won't be. We want to work the problem out.

MCCAIN: Have they tried to work it out?

CIRONA: We've met with them numerous times. I've never seen such cantankerous behavior. At one point they said our examiners couldn't get any association documents unless they made the request through Lincoln's New York litigation counsel.

RIEGLE: Well, that does disturb me—when you have to go through New York litigation counsel. What could they do? Is it too late?

CIRONA: It's never too late.

MCCAIN: What's the best approach? Voluntary guidelines instead of a compulsory order?

DECONCINI: How long will it take you to finish the exam?

PATRIARCA: Ten days.

GLENN: Have they been told what you've told us?

PATRIARCA: We provided them with our views and gave them every opportunity to have us hear what they had to say. We gave them our classification of asset materials and went through them loan by loan. This is one of the reasons the exam has taken so long.

SANCHEZ: We gave them our classification materials on January ____. On March 9 we received 52 exhibits, amounting to a stack of paper this high [indicating approximately two feet of material] responding to that. We went through every page of that response.

PATRIARCA: We didn't use in-house appraisers. We sent the appraisals out to independent appraisers. We sent the reappraisals to Lincoln. We got rebuttals from Lincoln and sent them to the independent appraisers. I don't think there was any case that Lincoln agreed with the reappraisal.

SANCHEZ: None where the reappraisal indicated insufficient collateral.

PATRIARCA: In every case, after reviewing the rebuttal, the independent appraiser has stood by his conclusion.

DECONCINI: Of course. They had to.

PATRIARCA: No. The rebuttals claim specific problems with the independent appraisers' reappraisals: "You didn't consider this feature or you used the wrong rental rate or approach to value." The independent appraiser has come back to us and answered those specific claims by saying: "Yes, I did consider that, and here's why I used the right rate and approach."

DECONCINI: I'd question those reappraisals. If you want to bend over backwards to be fair I'd arbitrate the differences.

The criminality surprises me. We're not interested in discussing those issues. Our premise was that we had a viable institution concerned that it was being over-regulated.

GLENN: What can we say to Lincoln?

BLACK: Nothing with regard to the criminal referral. They haven't, and won't be told by us that we're making one.

GLENN: You haven't told them?

BLACK: No. Justice would skin us alive if we did. Those referrals are very confidential. We can't prosecute anyone ourselves. All we can do is refer it to Justice.

DECONCINI: They make their own decision whether to prosecute?

BLACK: Yes. I also want to mention that we are already investigating Arthur Anderson because of their role in the file stuffing. We don't know whether they knew the purpose for which they were preparing the materials. I don't want to get harassed . . . no, that's not the right word;

I don't want to get criticized if we find out that Arthur Anderson was involved criminally and we have to make a referral on them. We don't want them to claim retaliation. We're in a tough spot.

With regard to what you can say to Lincoln, you might want to simply have them call us. If you really want to talk to them you can say that it will take us 7 to 10 days to finish the exam.

RIEGLE: Is this institution so far gone that it can't be salvaged?

PATRIARCA: I don't know. They've got enough risky assets on their books that a little bad luck could nail them. You can't remove the risk of what they already have. You can reduce what new risks they would otherwise add on.

BLACK: They have huge holdings in Tucson and Phoenix. The market there can't absorb them for many years. You said earlier that ACC was extremely good but ACC has gotten out of its former primary activity, homebuilding. I'm not saying they're bad businessmen but they had to get out of one homebuilding market after another. They had to get out of Colorado when they had bad models and soil problems. They also had to get out of their second leading activity, mortgage banking. They're now down to Arizona.

That's not a bad market but no one knows how well it will do over the many years that it would take to absorb such huge holdings in Tucson and Phoenix.

DECONCINI: So you don't know what you'd do with the property even if you took them over?

BLACK: Bill Black doesn't. Bill Black is a lawyer. We hire experts to do this work. Our study of their Arizona holdings was done by top experts. Our study of below investment grade corporate debt securities—what folks usually call junk bonds, but I avoid it because I don't know where you stand on such bonds—was done by top outside experts. I see in this Arthur Young letter that they criticize us for having an accountant with "only" eight years of experience. Well, I think . . . I don't see how you can claim eight years as inexperienced. But we didn't simply rely on him. We had . . . wasn't it Kenneth . . .

SANCHEZ: Yes. Kenneth Laventhol.

BLACK: We had Kenneth Laventhol, outside accountants, work on this. These are also some of the reasons the exam took time.

PATRIARCA: I think my colleague Mr. Black put it right when he said that it's like these guys put it all on 16 black in roulette. Maybe, they'll win, but I can guarantee you that if an institution continues such behavior it will eventually go bankrupt.

RIEGLE: Well, I guess that's pretty definitive.

DECONCINI: I'm sorry, but I really do have to leave now.

[The meeting broke up at this point, approximately at 8:20 P.M.]