



A MEMBER OF ARTHUR YOUNG INTERNATIONAL

## Arthur Young

1700 Valley Bank Center  
 Phoenix, Arizona 85073  
 Telephone: (602) 258-4831

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The Honorable Dennis DeConcini  
 United States Senate  
 328 Hart Senate Building  
 Washington DC 20510

Dear Senator DeConcini:

Certain questions have been raised by you and others with regard to Lincoln Savings, a California-chartered savings and loan association, which is wholly owned by American Continental Corporation (ACC) and its experience with the Federal Home Loan Bank Board (FHLBB). The following sets forth such questions and what I believe are objective answers to the questions.

1. What is Lincoln Savings' financial condition at December 31, 1986 and its operating results for the year then ended?

My firm, Arthur Young & Company, examined the financial statements of Lincoln Savings at and for the year ended December 31, 1986, and issued an unqualified opinion dated February 17, 1987 on such financial statements. Lincoln Savings' consolidated statement of financial condition at December 31, 1986 reflected stockholder's equity, as determined in accordance with generally accepted accounting principles (GAAP), of \$193,024,000 (or approximately 6.8% of its FSLIC-insured deposits) at that date. Its consolidated statement of operations reflected earnings before income taxes of \$81,689,000 and net earnings of \$48,958,000 for the year ended December 31, 1986.

2. In determining its earnings and stockholder's equity, did Lincoln Savings make provisions for potential losses?

Yes, the above-cited stockholders' equity is after valuation allowances of approximately \$28,000,000 at December 31, 1986 and the pretax earnings for the year are net of provisions for losses of \$12,500,000. In the course of my firm's examination of Lincoln Savings' financial statements, the firm tested the valuation allowances and the bases therefor and concluded such allowances were fairly stated in all respects material to Lincoln Savings' financial statements taken as a whole.

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3. Is the Federal Home Loan Bank Board currently conducting an examination of Lincoln Savings?

Yes, the FHLBB began an examination in approximately March 1986 and as of this date has not yet concluded such examination. Accordingly, such examination has been ongoing for approximately one year. One team of examiners conducted procedures from March to May 1986, and another group conducted comparable, and in many instances identical, procedures during the period August to October 1986. Since October, the FHLBB continues to seek additional information from Lincoln Savings, some of which has been previously provided to and been reviewed by the field examiners.

4. In your experience, is the duration of the FHLBB examination unusual?

Yes, examinations generally are conducted over a period of two to three months by field examiners, and final reports are usually issued within six months from the start of the examination. Hence, the duration of this examination appears to be clearly outside normal standards.

5. Have the procedures conducted by the examiners appeared to be different or more extensive than you believe is typical?

While I don't have first-person knowledge of the examiners' procedures, I have discussed the procedures with Lincoln Savings' management and legal counsel. Based on these discussions, the extent of loan file reviews, the number of appraisals ordered, the nature of the appraisal process including the location and experience of appraisers selected, the redundant procedures and requests for data, and the types of transactions examined, are unusual. By way of example, the examiners asked to (a) review loan files for loans which had been fully collected by the time of the examination, (b) review files for proposed securities transactions where, after analysis, the securities were not purchased by Lincoln Savings and hence no transaction occurred, (c) review data which had been reviewed in a previous examination, and (d) re-appraise properties using appraisers who were unfamiliar with the markets in which subject properties were located. These requests are not, in my experience, typical.

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6. Was the unusual duration of the examination and type and extent of the procedures used caused by the nature of Lincoln Savings operations?

While Lincoln Savings is not a typical association in that it is not a significant single family residential lender but rather tends to concentrate on land development and construction lending, it engages in transactions comparable to those entered into by other associations in Arizona and California. The focus of the FHLBB examination appears to have been centered on (a) land development projects, (b) investments in equity and noninvestment grade debt securities, and (c) commercial and construction loans. Because of the nature of the population growth patterns and economic climate in the western states, savings and loan associations in this area tend to rely more heavily on land development and commercial and construction lending to invest their resources, particularly since 1983, than do associations in other parts of the country.

Land development and commercial and construction lending tend to result in fewer transactions but transactions of greater dollar size than does residential lending. Thus it may be perceived that such lending activities bear greater risk. This perception, which is clearly held by the FHLBB, may not be accurate or realistic.

The residential lender is subject to interest rate risk. If rates rise rapidly, fixed rate loans lose their value rapidly and interest rate spreads quickly erode. Also, because variable rate loans usually have annual and life-of-loan interest rate caps, such loans are also highly subject to interest rate risk. The evidence of such risk is the failure of thrifts in the period 1979-1983. During this period, which was prior to deregulation, virtually all failures related to interest spread erosion by single family residential lenders.

In February 1984, when ACC acquired Lincoln Savings, Lincoln was in the position of other traditional thrifts in that its interest spread was insufficient to provide a level of profitability. Since ACC's primary business was land development and home-building, it looked to what it knew best to improve Lincoln's profits and reduce risk. After its acquisition, Lincoln acquired parcels of prime real estate in Arizona and other growth states, increased its construction lending, and sought other nontraditional investments. Since this strategy was put in place, Lincoln has realized aggregate after-tax earnings of more than \$141,000,000.

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Because the experience of most of the FHLBB's more senior examiners is with traditional single family lenders, Lincoln Savings is different from their prior experience. Also, the more junior examiners generally lack the business acumen to understand complex real estate development projects or complex investment strategies. Hence, while the examiners' decision to focus on real estate, commercial and construction lending, and equity and debt investments may have been proper, they appear to have had neither sufficient experience nor knowledge to deal with Lincoln's transactions effectively, thereby causing the examination to be more protracted than necessary.

Moreover, because Lincoln does not concentrate on single family residential lending, it does not fit the pattern for member institutions that the present FHLBB leadership has espoused publicly and as reflected in recent regulations. This fact has, based on my observations, led to unusually antagonistic positions and actions by the FHLBB towards Lincoln. This is difficult to fully understand because Lincoln's strategies have thus far proved successful and have turned an association headed for failure into a strong and viable financial entity. And, as stated earlier, Lincoln's strategies are not that different from other successful thrifts in the West. Most engage in real estate development, either directly or through joint ventures, many have far greater construction and commercial loan portfolios (as a percent of assets and in dollar volume) than Lincoln, and many have much heavier concentrations of noninvestment grade securities. Many of the associations with these characteristics are among the most profitable in the country and are considered to be the best managed by knowledgeable analysts.

Thus, the nature of Lincoln's operations should not have resulted in the protracted period of the examination or the unusual procedures employed. But, because the examiners did not have the requisite experience or knowledge to evaluate the types of transactions entered into by Lincoln, the nature of the business did, in fact, cause the examination to be inordinately protracted.

As to the nature of the procedures employed, the experience factor contributed to some of the redundant procedures. Others, I believe, based on observations of FHLBB personnel, were the result of the FHLBB'S resistance to Lincoln's nontraditional business profile and the fact that Lincoln does not fit into the mold desired by the FHLBB leadership.

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7. Lincoln Savings' representatives have asserted that the FHLBB examiners were unreasonable in their decision making and that at times their conduct bordered on "harassment." Did you observe personally any such conduct by the FHLBB?

The following support Lincoln's assertions:

- a. With respect to certain loans, a separate report was requested from Lincoln's independent accountants (the firm which preceded our firm) regarding the appropriateness of Lincoln's accounting for such loans. That firm issued a report concluding that Lincoln's accounting was appropriate under relevant professional literature. The FHLBB did not accept this report and requested a second opinion by another firm. Our firm was contacted by both ACC and the FHLBB to render the second opinion. Our firm independently reviewed the subject loans and issued an opinion concurring with the other accountant's opinion. The FHLBB has subsequently rejected our opinion as well. Such rejection was made by a person with less than eight years' experience in accounting practice. Thus a person with relatively little experience has rejected the opinions of two international accounting firms.
- b. On February 6, 1987, the FHLBB notified Lincoln that it had determined that specific reserves in the amount of \$36,634,000 were required to be recorded. Such reserve request did not (a) take into account the reserves already established by Lincoln, (b) data supplied to the FHLBB by Lincoln which clearly indicated that certain appraisals on which such reserves were predicated were incorrect, or (c) that certain assets were not subject to their reserve procedures because they were operating properties and not investment assets. Moreover, the notice stated, "The loss reserve directed by the Supervisory Agent must be established before any such subsequent reappraisals will be accepted for consideration." As the Supervisory Agent had been informed that Lincoln believed the requested reserves to be based on erroneous data, the issuance of such a notice and the terms thereof are unreasonable and unusual based on my prior experience with the FHLBB.

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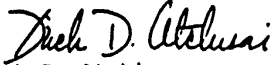
- c. On at least two occasions that I am aware of the supervising agent, in group meetings, indicated the examination was complete and a final report would be forthcoming shortly. Additionally, the agent was specifically asked if all issues of concern to the FHLBB had been communicated to Lincoln, to which question the agent answered affirmatively. At this date new issues have been raised and a final report has not been issued. This is in spite of the fact that a draft report was prepared and provided to Lincoln in early November 1986 and again in December 1986.
  - d. The examination became a fluid event. The first period examined was through December 31, 1985; then through June 30, 1986; and then through September 30, 1986. Draft reports have been issued at various dates stating, "The following agenda items, subject to final review, summarize the results of our examination of Lincoln Savings and Loan Association as of ..." However, after each draft, and apparently after the field examiners concluded they had completed the examination, new inquiries have been made and additional data has been requested from Lincoln. I have specific knowledge that this has caused Lincoln great expense and has distracted its management from the daily operations of the thrift's business.
  - e. Data requests from the examiners have clearly been redundant and, based on my experience, excessive as to the amount of data and level of detail requested.
  - f. Lastly, the examiners' interpretations of accounting principles and their own regulations and examination guidelines have been consistently and unreasonably pejorative to Lincoln. In meetings I've attended the FHLBB personnel have appeared, without apparent cause, to be openly hostile and inflexible towards Lincoln personnel and their representatives.
8. Do you believe the eventual outcome of the examination will be detrimental to Lincoln's well being?

Based on the draft reports presented to Lincoln, I believe the results will indicate Lincoln fails to meet the minimum net worth requirement as determined by the FHLBB staff. I don't believe the facts and circumstances will, if objectively viewed, support such a conclusion. Thus, the final report will in all likelihood be detrimental and inappropriately so. This is not to say that Lincoln could not, or should not, improve certain of its internal procedures. But based solely on my personal observations to date, the final report can be expected to be unduly harsh.

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I trust the above has been responsive to your questions. I have attempted to answer each question objectively and without bias either towards Lincoln or the FHLBB.

Yours truly,



Jack D. Atchison  
Managing Partner, Phoenix Office