TO: John F
FROM: Gwendolyn
DATE: 2 April 1987

RE: meeting this afternoon with Senators Cranston, Glenn, and DeConcini

I have attached them memo you requested for your meeting this afternoon. It discusses the valuation problem and has an appendix that goes further into the issue as a whole.

You have agreed to discuss only the issue of the appraisals, and only that in the vein of: Please, let's get a third party appraisal or something in the spirit of achieving a satisfactory and speedy resolution to this dispute.

You and Senator DeConcini have also agreed not to bring up the issue of capital regulations (discussed in the Appendix, FYI) because that will be resolved in the court cases I have related below. Senator DeConcini is also going to plead that, until the issue is resolved, the two parties quite sniping at each other.

Beyond this, the two parties will have to settle their differences.

SPECIAL COUNSEL
EX. 70

APPRAISAL OF ASSETS ISSUE

The appraisal issue has to do with land appraisals. Before I explain, let me first point out that the overappraisal of land values by private examiners on behalf of thrifts has been somewhat of a scandal of late.

In any event, the accountant verifies Lincoln's claim that some of the land it is developing has been underappraised by FHLBB appraisers. The accountant has recounted to me this scenario:

In ordering the appraisals, the FHLBB hired appraisers from California -- and hence, inexperienced in the AZ and Georgia real estate markets -- to evaluate AZ and Georgia properties. In addition, the appraisers may have been pretty inexperienced in evaluating the kinds of property under consideration. This is because, as he points out, many of these appraisers are more versed in evaluating residential real estate holdings than the commercial ones in question. The appraisers undervalued the real estate they examined, and as a result, the Bank Board required Lincoln to add substantially to its capital reserves. (This is standard procedure, as I understand it, if a thrift has overvalued assets, thich is what the appraisers determined.)

When Lincoln received the appraisal reports, it hired AZ and Georgia appraisers to redo the work, and discrepancies emerged between the two reports. Some of these were mathematical, others were due to other problems. Consequently, Lincoln approached the Board, requesting that it reconsider the issue. The Board agreed to do so, but required that Lincoln add the required amount to its capital requirements before it would do so.

One specific example that both the accountant and Lincoln have referred to is the development known as the Phoenician, a resort which has not yet been completed.

APPENDIX

Explanation of capital regulations

Before 1986, thrifts were required to have reserves equal to 3% of federally insured deposits. In August of 1986, the FHLBB promulgated regulations requiring institutions to increase their minimum capital requirements to 6% of insured deposits. Under a complicated grandfather rule, institutions have a transition period of several years to bring their institutions into compliance with this new regulation. This rule applies to all thrifts, regardless of the sort of activities in which they are involved.

The capital regulations also have a special provision regarding direct investments, which by definition only applies to institutions that make so-called direct investments. The definition of this activity includes real estate investment, equity securities, and involvement in the institution's service corporation (S&Ls are allowed to set up service corporations which are a subsidiary of the parent and are allowed to engage in all sorts of activities coveted by banks, included securities and real estate brokerage).

The direct investment provision in the capital regulations requires S&Ls with direct investments in excess of a specified amount (discussed below) to add 10% of that excess to their net worth requirements.

Lincoln has $600 million in disputed direct investments, and this regulation would require the institution to add reserves equal to 10% of this amount -- $60 million. This is one of the issues which you were requested to bring up at the meeting, but we have all agreed you should not. Dennis DeConcini will not either.

History of the direct investment debacle

In 1982, the Garn-StGermain Act allowed institutions to broaden their activities. It also allowed the states to broaden their laws with respect to direct investment (defined above). The overriding reason for this expansion was to allow S&Ls to engage in [redacted]ditable activities in order to offset the losses they su[redacted] in the wake of high interest rates and the recessi[redacted]

The [redacted]western states were especially aggressive in expanding these laws. Texas and California are notable in this regard. In 1983 and 1984, purported abuses by the Texas S&Ls led to changes in these rules, not by Congress, but by the FHLBB. Ed Gray was particularly instrumental in the effort to narrow the powers available to S&Ls.

In 1984, the Bank Board promulgated regulations to limit direct investment, both by federal and state chartered institutions. Effective 12/10/84, the Bank Board limited direct investment to 10% of an institution's assets, or twice its net worth.

A grandfather provision allowed institutions that were more heavily involved to continue with those projects, but as those projects concluded, the S&Ls were barred from starting new ones until they were in compliance with the new regulations.

In order for a project to qualify under the grandfather provision, the FHLBB required that "definitive plans" had to be in place prior to the effective date. The Bank Board claims that it intended that there be a commitment to a third party, but third party involvement is not spelled out in the regulations. Lincoln, in anticipation of the new regulations, submitted its plans for projects to the FHLBB with respect to lands it already owned as well as plans to put new funds into its service corporation. These plans, however, did not have a third party commitment, and there in lies the dispute over the $600 million in Lincoln's direct investments.

Lincoln has sued the FHLBB over this issue. Its suit addresses to issues: First, can regulators take away what Congress has granted? and, second, if so, has Lincoln complied with the regulations with respect to the purchase its submission of direct investment plans prior to the effective date?

In addition, Lincoln has filed a petition with the FHLBB asking for the recusal of Ed Gray in any matters involving Lincoln Savings. This petition asks that if Gray refuses to recuse himself, that the other Board members disqualify him. Failing that, Lincoln is asking for discovery and conduct of an evidentiary hearing on an expedited basis for the purpose of exploring the extent of Gray's bias and prejudgement toward Lincoln.

<u>The Henkel story</u>

Lee Henkel, who has removed himself as a nominee for the Board of Directors of the Bank Board, got himself into hot water when he proposed a clarification of the grandfather rule during his first hearing with the Board. The rule would directly have benefited Lincoln, but it is not clear that it would have benefited [redacted] thrifts. It did not help that Henkel has equity in Lincoln, furthermore, had a $250,000 loan from the S&L.