To: Chairman Proxmire/Ken McLean

From: Bart Naylor

Re: Preliminary findings, dead thrift case studies

July 26, 1988

All three cases are primarily due to fraud and insider dealing. In each, real estate developers acquired thrifts essentially as a cheap source of funds. Without disinterested creditors checking the viability of projects, these entrepreneurs aggressively acquired, developed and constructed a variety of office buildings, shopping malls, and in some cases, wind mills and other speculative ventures. If and when a project soured, sending a loan into default, the developer would "flip" the property, creating fictitious companies that would buy the land at inflated prices. The thrift would finance the new "buyer," who would pay off the old loan. In some cases, the thrift would itself purchase the project under its direct investment authority. These flips created the appearance of financial health, yet disguised mounting losses and delayed regulatory efforts to uncover the problem.

AMERICAN DIVERSIFIED SAVINGS BANK, Costa Mesa (Orange Co.), Calif.

Prior to acquiring the thrift in 1983, Ranbir Sahni had purchased HUD-subsidized properties, and rehabilitated them with funds obtained through syndications. Sahni's investors were interested in tax breaks so that the losses generated by these ventures were as important as any profits. (The SEC investigated some of these deals and he was sanctioned shortly after he received approval to acquire the thrift.) By purchasing Tokai Savings and renaming it American Diversified Savings Bank, Sahni accelerated his syndication ventures. Between 1983 and early 1986, he expanded the book value of his thrift's assets from some $10 million to some $1.3 billion. Most of these investments were in office buildings, hotels, or multi-family units, with about $100 million in for windmills, an ethanol plant and other "hobby" assets.

During the first annual examination, regulators found his records in serious disarray. Subsequently, ADSB auditors Touche Ross & Co. questioned the thrifts net worth. (Sahni dismissed the Big Eight accounting firm.) Regulators stepped up their examination focussing on the appraisals of properties. But Sahni countered, according to a FHLBB lawsuit, by flipping the properties to conspirators who would purchase them with ADSB loans.

For example, Sahni's appraisals showed that a casino project in Las Vegas was worth $14 million. An appraisal commissioned by the FHLB/S.F. showed the property was worth half that. On the eve of a

with regulators to discuss the discrepancy, Sahni "sold" the
) an affiliate for exactly the value of his appraisal.

Because of these flips, an impressive 95 percent of ADSB loans and investments are sour. Of the $1.3 billion in book value assets, FSLIC estimates that it may recover no more than $300 million.

Sahni was able to attract deposits through a "money desk." His lavishly appointed offices were on the upper floors of a suburban highrise in Costa Mesa (ironically marked on the outside "Great Western Bank," a conservatively run thrift.) ADSB had no retail branch. Rather, it engaged in "dialing for dollars" by contacting large investors and offering them a premium for their $100,000 certificates of deposit, all backed by federal deposit insurance. Because of insurance, Sahni attracted all the money he needed. (After the regulatory takeover when conservators managed the money desk and they declared to each depositor that the thrift was insolvent, the thrift still faced no trouble attracting limitless deposits provided they paid about a 50 basis point premium.)

NORTH AMERICAN SAVINGS AND LOAN ASSOCIATION Costa Mesa (Orange Co.), Calif.

One of the more colorful cases in the thrift pathology portfolio, North American was operated by a former dentist named Duayne Christiensen who died in a mysterious one-car crash on his way to a meeting with regulators who were closing his thrift.

Along with thrift vice chairman Janet McKenzie, North American perpetrated extraordinarily bold land flips, according to legal claims of regulators. McKenzie held naming parties to create bogus companies that would trade the same property, all financed by North American. The most extreme case was an 20-unit stucco condominium complex in Tahoe. Originally purchased for about $2.5 million, it was sold during the course of three years to Christensen/McKenzie-controlled firms until the price reached (!) $70 million.

In all, North American booked about $500 million assets that regulators value at about $200 million.

North American had no retail branches and collected all deposits through a money desk.

(Three days before his death, Christensen had signed his $10 million life insurance police to McKenzie. During the previous two years, three other male associates of McKenzie also died violently--one strangled by a piano wire, one by beating, and one in an airplane crash. She has never been charged by police.)

LAMAR SAVINGS & LOAN Austin, Texas

Now a part of Southwest Savings (the second of the so-called Southwest Plan deals), Lamar was formerly run by Stanley Adams. Adams was an unusual thrift operator, and once filed a formal application for a branch on the Moon. (Regulators did not act on it.)

Adams made loans to his real estate ventures that were poorly considered. When the Texas economy soured, and the ambitious growth proposals assumed in his plans failed to materialize, he began to projects.

... ms allegedly engaged in a "daisy chain," where he sold bad assets to other thrifts during his examination, and would buy them back when examiners arrived at that shop. One of those thrifts was Cities Savings, which was also owned by Adams.

Of the $1.8 billion in assets that Adams booked, FSLIC estimates the current market price at about $600 million.

## ISSUES

### REGULATORY SPEED

Because these thrifts problems grew rapidly, it was important for regulators to identify the scams quickly and resolve them. In each case, however, two to three years elapsed before regulators seized control. Where is the delay?

At ADSB, regulators found incomplete records during the first annual review. Some FHLB/S.F. suggested that the law provide this be enough basis to issue a cease-and-desist order. During the second year's examination, examiners noted the thrift made essentially no home loans, and recommended to FHLBB in Washington that its FSLIC insurance be rescinded on the grounds that it was not serving the function of thrifts in the housing market. FHLBB attorneys rejected the recommendation. Finally, after a more thorough examination, with independent appraisals, FHLB/S.F. gathered enough evidence to seize control and place ADSB in a conservatorship (where the thrift was managed under consignment and strict supervision).

At North American, regulators identified problems early but the shear volume of land-flips delayed understanding of the scope of the problem.

At Lamar, regulators found problems during the first examination and recommended an enforcement action. This was considered but suspended by FHLBB in Washington. They requested additional information. After another year, enough proof was provided.

These examples suggest a number of factors.

Washington was not aggressive, according to some. "Due process" is basic to the law, several attorneys stressed.

Examinations are also cited.

Formerly, examiners neglected risk assessment, which wasn't necessary for thrifts making traditional loans, according to Michael Patriarca, FHLB/S.F. enforcement chief. Under his supervision, risk assessment is stressed.

Another FHLB/S.F. examiner suggested that regulations were designed to thwart fraud. Provided the paperwork was in order, examiners were ill-equipped to identify problems.

A FHLB/Dallas examiner suggested the reguilations were aimed at net worth adherance. If the thrift claimed it was solvent, examiners didn't check deeply.

One former official claimed inexperience and disarray at the las.

DIRECT INVESTMENTS

All three thrifts were heavily engaged in direct investments, where they owned real estate. In addition, they owned service corporations to whom they lended that invested in real estate.

Direct investments and problem thrifts are closely correlated. Of the 250 Texas thrifts, 100 are in trouble. Virtually none of these troubled thrifts are primarily single-family lenders. Most of the remaining 150 healthy thrifts are primarily single-family lenders.

Some may argue that thrifts in Texas are beleaguered by a depressed farming and oil industry. However, more than 30 percent of all thrift losses are connected to thrifts based in California's prosperous Orange County. (ADSB, North American, Beverly Hills, Financial Corp of America, Lincoln Savings . . . ) In his business plan, American Diversified chairman Sahni argued that traditional mortgage lending was too risky for thrifts and they should diversify (hence the name he chose). Had these thrifts remained traditionally oriented, they would not (could not) have suffered such huge losses. Great Western Bank, another Orange Co-based thrift, is a traditional thrift and is one of the most profitable in California.

Under regulatory order, the FHLBB has limited direct investments to a multiple of net worth.

Given the close association of direct investments with problem thrifts, as well as the regulatory challenge (and delay) in tracking down scams such as those at Lamar, ADSB and North American, is the freedom of direct investments worth the huge price? Have the regulators learned to police the problem?

SOUTHWEST PLAN

Resolving the huge and mounting losses of "zombie" thrifts (dead by still open) in the Southwest requires attracting new capital quickly. To accomplish this, the FHLBB devised the "Southwest Plan" where the 100 defunct thrifts would be consolidated and sold to proven managers would add capital.

However, judging by two criteria--speed, and new capital--the Southwest Plan is failing. Of the 24 projected deals, three have been capitalized. And essentially no new capital has been added, other than approximately $3 million in pledges associated with one of the deals.

For Lamar, the only "new" capital is the already dwindling networth of the acquiring firm which happens to be named Southwest Savings. This was a $2 billion Fort Worth-based thrift with about 1 percent net worth, well below the regulatory minimum. By agreeing to manage Lamar and two other thrifts, Southwest chairman Todd Miller essentially won a reprieve from FHLB/Dallas which might have placed his thrift into a conservatorship. Under terms of the deal, the FHLBB has granted the new combination a loan that must be repaid in 10 years. During this period, Miller must husband his resources and capital jealously in the hopes that real estate prices will te and elevate the thrifts investment and loan portfolio.

In the meantime, by acquiring Lamar and the other thrifts in the package, he has doubled his monthly losses from some $50 million, to some $110 million.

FADA

The Federal Asset Disposition Association was created two years ago to utilize private sector experts to liquidate dead thrifts. Its progress has been slow, and the organization has come under fire for conflicts of interest. (One of its attorneys was a borrow from Lamar when FADA was hired to dispose of its bad loans.)

At Lamar, FADA has made slow progress. One FHLB/Dallas official said FADA liquidators were better than FSLIC liquidators.

At ADSB and North American, FADA was not used. Instead, FSLIC is liquidating the thrifts with the help of private contractors. FSLIC officials there believe FADA is not necessary. Given the fact that they can already use private sector expertise, these FSLIC officials question FADA's nature.

MONEY DESKS

All three thrifts used money desks, though Lamar also had a retail network of some 40 branches. The money desk became a source of nearly boundless funds, permitting rapid growth. Simply limiting deposit gathering to a retail branch would have been a natural limit to growth. In fact, despite the premium paid by insolvent thrifts, obtaining money this way is cheaper than through a retail branch because there are few employees and bricks-and-mortar to finance.

Since these monies were essentially FSLIC-subsidized loans deployed to real estate speculation, is this a distortion of the purpose of FSLIC?

Should money desks be limited?