



Office Memorandum

Federal Home Loan Bank Board

Eleventh District
Office of Supervisory Agent

To: E. J. Gray, Chairman
Federal Home Loan Bank Board

From: J. M. Cirone, Principal Supervisory Agent *JMC*

Date: September 25, 1986

Subject: Lincoln S&LA (FHLBB No. 3805)
Irvine, California
Allegations Regarding Examination Process

This is in response to your memorandum of September 22, 1986, regarding the article appearing in the September 20, 1986, edition of the Washington Post. That article contained allegations attributed to officials at Lincoln Savings, which focused on the length of the examination and the disclosure of confidential information about the examination. This memorandum responds to those allegations.

1. The association's lack of cooperation has prolonged the examination.

The regularly scheduled examination of Lincoln Savings commenced March 12, 1986, and has continued to the present. During the initial weeks of the examination, routine investigation revealed a number of areas of concern requiring more indepth review. These include:

- Loan underwriting and appraisal deficiencies (and in some cases no appraisals whatsoever)
- Heavy direct investment in real estate development
- Origination of large real estate acquisition, development and construction loans
- Heavy concentrations of loans and investments by type and location
- Essentially no single family home lending (Lincoln originated just eleven (11) single family home mortgages between January 1985 and the beginning of the examination)
- Heavy and often speculative investments in junk bonds, equity securities, and partnerships

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- Possible violations of the direct investment regulation
- A large volume of transactions between affiliated entities and individuals
- Speculative trading of forward commitments and options
- Rapid liability growth and risky liability composition
- A substantial negative interest margin, substantial operating losses, and dependence on non-operating (and possibly non-recurring) revenues

Because of these concerns, the scope of the examination was substantially expanded to obtain detailed analysis of these areas. This process required the assignment of additional examiners, an accountant, and appraisers to this examination. The majority of the association's lending and real estate investment activity is originated by its subsidiaries, which operate out of the holding company, American Continental Corporation, which is headquartered in Phoenix, Arizona. The association's accounting records are also maintained in these Phoenix offices. This situation obviously necessitated the placement of examination crews in both the association's Irvine, California office and the service corporation offices in Phoenix, which has created a logistics complication.

While Lincoln has not provided all of the information requested by the examiners, the examination to date has increased rather than allayed our initial concern about each of the areas outlined above.

The initial review of large loans and real estate investments disclosed material underwriting deficiencies, including appraisals not prepared in accordance with R11b, and in the case of some real estate investments, no appraisals. Our appraisal concerns resulted in the ordering of 18 outside appraisals, the majority of which have not been received. Our underwriting concerns resulted in an expansion of scope to include loans and real estate investments made since the start of examination. Similar deficiencies have been found.

Due to the high concentration of investments in land in the Phoenix and Tucson areas, the district appraiser performed a preliminary study of these markets. His study disclosed a potential over-supply of building lots in both markets. Consultants were hired to perform formal studies of these market areas. The results are yet to be received.

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The association's investments in junk bonds and equity securities were reviewed by our examiners and accountants. Due to their concerns we have engaged outside consultants with expertise in this field to assist in our review. The results of their review are due in early October.

The above described work, which is obviously time-consuming under normal circumstances, was further delayed by uncooperative management. The association has been exceptionally slow in responding to requests for data, such as documents needed to facilitate the completion of outside appraisals and sales contracts to support alleged sales of land. Some of this data was obtained only after the Director of Examinations phoned senior management; some of it has never been obtained. The situation was aggravated during the summer when weeks went by during which our examiners were not provided requested materials. The situation has further been complicated by the intrusion of the association's outside counsel.

For example, on May 8, 1986, the Supervisory Agent asked the association for information on its junk bond holdings (which currently amount to over \$300 million, including \$100 million in a partnership run by the well-known corporate raider, Ivan Boesky). The association provided little if any of that information; instead, the examiners received an argumentative letter (dated June 10, 1986), from a New York litigator, Arthur Liman of Paul, Weiss, Rifkind, Wharton & Garrison (see attached copies of the May 8 and June 10 letters).

On July 3, 1986, the examiners held a meeting with management to discuss the previously mentioned underwriting deficiencies. The examiners never had a chance to present their findings; instead, the meeting consisted of attacks by Charles H. Keating, Jr., (who is not an officer or director of the association but nevertheless dominated the meeting) on the Bank Board. Mr. Keating's attacks included threats of litigation, such as a threat to impose personal liability on a representative of the Bank (see memorandum on the meeting) (copy attached).

On July 15, 1986, the Director of Examinations received a letter from the association's counsel, Kaye, Scholer, Fierman, Hays and Handler, asking that all requests for any documents or information from Lincoln should be directed to Ms. Karen Katzman, a litigation attorney of that law firm, located in New York City. The author of this letter, Peter Fishbein, was contacted by telephone by this Bank and the Office of Enforcement and was told this arrangement was unacceptable. Subsequent to that conversation, representatives of this Bank, the Office of Examination and Supervision, and the

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Office of Enforcement met with Mr. Fishbein in the Federal Home Loan Bank Board's Washington offices to discuss the examination.

The discussion process resulted in an approximate two-week period during which the association refused to let examiners have access to any information or documentation. During the two months since the agreement, the flow of information and documentation has been sporadic and has stopped again on at least two occasions, necessitating conference calls between the examiners, the Office of Enforcement, and a representative from the institution to resolve alleged difficulties.

Mr. Fishbein's letter also contained a number of allegations about the examination and some thinly veiled threats to sue the Bank Board. The vast majority of these allegations were false and were refuted in detail in the Director of Examination's August 8 reply. (This August 8 letter also specifies a number of incidents in which the association has hindered the examination.) While Mr. Fishbein has written a further letter insisting that the Director of Examinations is "misinformed," Mr. Fishbein's letter lacks any specifics and retreats from a number of his earlier allegations (see attached copies of letters of July 15, August 8 and September 10). (We note that Ms. Waxman, the Sidley and Austin lawyer quoted in the Washington Post article, has not previously surfaced in this examination; to date Lincoln has chiefly relied on the Paul Weiss and Kaye, Scholer firms).

After the Washington meeting Lincoln sent a Kaye, Scholer lawyer to Phoenix. Since late July that lawyer, rather than association personnel, has handled most of the examiners' inquiries. While some information has been forthcoming (at least sporadically), many requests—even simple requests for specific files—have gone unfulfilled for weeks. These outstanding requests are summarized in Examiner Fitzgerald's letter of September 15, 1986 (copy attached).

Despite these problems, the majority of information has now been obtained and examiners are in the process of completing the examination.

2. The Bank Board has not "leaked" information on Lincoln; however, Lincoln has leaked information on the examination to at least one major borrower.

The Washington Post article contained allegations by Lincoln officials that the Bank Board is leaking information about the examination to discredit Mr. Keating. In a statement issued through his attorney, Mr. Keating indicated that Lincoln is

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worried that "leaks" about the examination "are being used to hurt Lincoln."

This concern was expressed to Deputy Director Stephen Bershkovitz, Office of Enforcement, by letter, dated September 9, 1986, from Peter Fishbein of Kaye, Scholer. Mr. Fishbein's letter claims that, in early August 1986, an employee of Salomon Brothers told an officer of Lincoln that an officer of Salomon had heard that Lincoln was having problems in Louisiana. This information was purportedly given to Salomon Brothers from an unidentified "top executive" of a "major California thrift." Mr. Fishbein's letter indicates that apparently the executive's comments relate to the foreclosure of an approximately \$15.0 million loan in Louisiana made by a wholly owned service corporation of Lincoln and suggests that it is highly unlikely that an executive of a California thrift would know of such a small and remote situation (Mr. Fishbein's characterization) unless he was told by Bank Board personnel involved in the pending examination at Lincoln. We are not aware of facts that support Mr. Fishbein's allegation, which quite obviously is based on speculation and supposition. We would further point out that the Louisiana situation is no secret, as it involves extensive federal court litigation to which Lincoln is a party. In any event, we understand that Mr. Bershkovitz is following up on this matter.

In this regard, on two separate occasions, representatives of Lincoln or its legal counsel have expressed concern that this Bank's Board of Directors includes Lincoln's competitors and that confidential information would fall into the hands of such competitors. At a pre-closing meeting held on July 3, 1986, Mr. Keating expressed such concern to the examiners. It was clearly represented to Mr. Keating by representatives of Examinations that the Agency function, consisting of both Examinations and Supervision, was a distinctly separate function of the Bank and that the Bank's Board of Directors does not have access to examination workpapers.

Further, in response to Mr. Fishbein's letter of July 15, 1986, (copy attached) wherein this relationship was again questioned, the Director of Examinations by letter dated August 8, 1986 (copy attached), clearly indicated that, while Examinations and Supervisory personnel are employees of the regional Banks, they are agents of the Bank Board, not the San Francisco Bank, for the purposes of supervisory and examination activities. The Director also stated that the Bank's Board of Directors does not direct examinations and is not kept informed of the Bank Board examination and supervisory process.

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With respect to such allegations, we note that representatives of Lincoln disclosed details of the confidential ongoing examination to a borrower (Wolfswinkel Group) respecting the possible reclassification of a loan as a joint venture. This resulted in a threat of litigation by the borrower (copy attached.)

To summarize, the Bank and Bank Board have not "leaked" information about the examination but Lincoln has; the Bank and Bank Board have not engaged in harassment but Lincoln has; and the Bank Board has attempted to expedite the examination while Lincoln has continuously obstructed and delayed it.

JNC/cg/C. A. Deardorff

Attachments (8)

cc: W. K. Black	w/o attachments
S. Fairbanks	" "
S. Marshkovits	" "
J. C. Price	" "
A. W. Smarynski	" "
R. Stewart	" "
M. Patriarca	" "
D. S. Adams	" "
B. J. Davis	" "

bcc: Supervision Staff

Record Copy: Supervision
Office of the President

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