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GOVERNOR'S TASK FORCE
ON THE SAVINGS AND LOAN INDUSTRY

REPORT TO

THE HONORABLE WILLIAM P. CLEMENTS, JR.,

GOVERNOR OF THE STATE OF TEXAS

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GOVERNOR OF THE STATE OF TEXAS

January 25, 1988

By Executive Order WPC-87-11 dated May 13, 1987, William P. Clements, Jr., Governor of the State of Texas established the Governor's Task Force on the Savings and Loan Industry ("Task Force").

The Task Force consists of the following persons:

Bayard H. Friedman, Chairman
John C. Dawson, Jr.
John Wilson Kelsey
Robert G. Kralovetz
S. Don Norris (Replaced Rolan G. Tucker in June 1987)
James L. Sexton
R. Dary Stone

The Executive Order charged the Task Force as follows:

> The TASK FORCE is charged with the responsibilities of ascertaining a clear and concise statement of the current status of the industry; examining the adequacy of the oversight of the industry currently provided by the State; seeking ways to improve the coordination of State and Federal authorities; making any other recommendations dealing with the savings and loan industry which the Task Force deems appropriate; and perform such other duties as may be requested by the Governor.

It is generally recognized that the savings and loan industry in Texas is experiencing a crisis with an intensity

and severity unknown to the industry in this State. Federal action, through the Federal Home Loan Bank System and the Federal Savings and Loan Insurance Corporation, must be the principal rehabilitative force, to the extent that therein resides the requisite financial resources. Since the actions of these Federal organizations are beyond the control of State government, the focus of the Task Force was primarily directed to State responsibilities and actions. The Task Force feels that State action can help prevent a similar situation from occurring. It is toward this goal that the Task Force primarily directed its effort.

In carrying out its responsibilities, the Task Force held formal meetings with the following governmental agencies and industry representatives:

L. Linton Bowman, III, Texas Savings and Loan Commissioner and members of his staff; Edwin Gray (then Chairman of the Federal Home Loan Bank Board) together with William K. Black (then Deputy Director of the Federal Savings and Loan Insurance Corporation) and Mary Ellen Taylor (then assistant to the Chairman of the Federal Home Loan Bank Board); Roy G. Green (then President of the Federal Home Loan Bank of Dallas), H. Joe Selby, Craig M. Stirnweis and various staff persons with the

Federal Home Loan Bank of Dallas; representatives of the Texas Savings and Loan League including Executive Vice President Tom S. King, Senior Vice President Jim Reynolds, Alan D. Myers, Jr., James B. Reeder, Wade Nowlin and Jack Crozier; and M. Danny Wall, current Chairman of the Federal Home Loan Bank Board. In addition, the Task Force met with representatives of the United States Treasury.

Further, the Task Force met with certain potential private investors and received reports from various governmental agencies and industry representatives. Individual members of the Task Force met with numerous industry and agency representatives.

The Task Force makes the following Report to the Governor of the State of Texas.

I

HISTORICAL PERSPECTIVE AND CURRENT STATUS OF THE SAVINGS AND LOAN INDUSTRY IN TEXAS

The Task Force sought to determine the current status of the savings and loan industry in Texas and its causes. A brief summary of the statutory and regulatory framework within which the savings and loan industry of Texas has evolved is appropriate so that the findings of the Task Force may be viewed in the proper perspective.

Historical Perspective

In the early 1930s, Congress devised a system to promote individual home ownership by making available economical financing. Under this system, savings and loan institutions were established to serve the financial needs of local communities. The statutory foundation for a national savings and loan industry was created by the enactment of three Congressional acts; the Federal Home Loan Bank Act (the "FHLB Act"), the Home Owners Loan Act of 1933 (the "HOLA"), and the National Housing Act of 1934 (the "NHA"). The FHLB Act provided for the creation of the Federal Home Loan Bank Board (the "FHLBB") and the establishment of the system of

Federal Home Loan Banks. The HOLA authorized the FHLBB to charter Federal savings institutions ("Federal Associations"). The NHA established the Federal Savings and Loan Insurance Corporation ("FSLIC") to insure the accounts of eligible institutions in accordance with the provisions of the NHA. Under the NHA, all Texas-domiciled Federal Associations and FSLIC-insured State Associations are required to buy stock in the Federal Home Loan Bank of Dallas (the "FHLB of Dallas"). As stockholders, the associations are authorized to borrow funds from the FHLB of Dallas. This statutory scheme provides the framework for the Federal regulation of a national savings and loan industry.

Prior to 1913, Texas had no laws regulating savings and loan associations. Between 1913 and 1923 the Secretary of State in Texas was responsible for chartering savings and loan associations and the Commissioner of Insurance and Banking was responsible for supervising the chartered associations. The Insurance Commissioner issued savings and loan association charters between 1923 and 1929. Thereafter, until 1961, the Texas Banking Commissioner chartered and examined savings and loan associations.

In 1961, the Texas legislature established the Texas Savings and Loan Department (the "State S&L Department") and

placed it under the direction of the Texas Savings and Loan Commissioner (the "State Commissioner"). The State Commissioner is appointed by the Finance Commission of Texas (the "Finance Commission").

The Texas Savings and Loan Act (the "Texas Act") was enacted in 1963. It sets forth the substantive criteria for the creation and regulation of Texas-chartered savings and loan associations ("State Associations"). Under the Texas Act, the State Commissioner is charged with promulgating (together with the Savings and Loan Section of the Finance Commission) regulations to effectuate the purposes of the Texas Act, ruling on applications for new charters filed pursuant to the Texas Act, deciding other applications filed in accordance with the Texas Act and the regulations promulgated thereunder, and enforcing the Texas Act and such regulations.

The evolution of the savings and loan industry has been affected by other Congressional actions. The Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA"), the Garn-St Germain Depository Institutions Act of 1982 ("Garn-St Germain"), and the Competitive Equality Banking Act of 1987 ("CEBA") were enacted in response to significant changes which occurred in the financial services industry.

During the late 1970s, market interest rates soared. Federally-insured depository institutions were governed by deposit interest rate regulations under Federal Reserve Regulation Q which sharply restricted the interest rates that those associations could pay on retail deposits. Disintermediation, the movement of funds out of depository institutions, occurred as other financial service institutions were able to develop products which offered higher yields. Federal agencies attempted to provide relief for banks, thrifts, and credit unions through regulatory actions. When the authority of the regulators was legally questioned, Congress enacted the DIDMCA which provided for a phasing out of Regulation Q, authorized nationwide NOW accounts (like bank checking accounts), increased federal deposit insurance limits from $40,000 to $100,000 per depositor, expanded the lending authority (primarily consumer lending) of Federal Associations, preempted state usury laws, and authorized mandatory reserves on deposits at banks, savings and loans, and credit unions.

Interest rates continued to rise and the cost of funds to savings institutions increased significantly. Most savings institutions held assets including fixed-rate mortgage loans, the yields of which could not be changed to compensate for the increased cost of funds. By 1981, most savings

institutions were losing money and a substantial portion of the industry was technically insolvent or approaching insolvency. Congress acted to provide a legislative solution for the situation. Garn-St Germain expanded the loan and investment authority of Federal Associations, eliminated the restrictions on loan-to-value ratios for residential mortgages, permitted a Federal Association to utilize loan-to-value ratios of up to 100 percent, and expanded the authority of a Federal Association to make commercial real estate loans in amounts up to 40 percent of its assets. This expanded lending authority, granted to create new income-generating opportunities, coincidentally permitted Federal Associations (as well as other Federally-insured depository institutions) to compete with State Associations that already had the authority to make commercial real estate loans. Garn-St Germain increased the authority of a Federal Association to invest in certain commercial paper and corporate debt securities and to make consumer loans to the extent that such investments and loans do not exceed 30 percent of its assets. Garn-St Germain also authorized the use of new money market deposit accounts to permit Federal Associations (as well as other Federally-insured depository institutions) to compete with money market funds.

As deregulation swept the financial services industry, the ability of depository institutions to secure almost

unlimited funds, the significant competition between financial service firms, and the expanding economy and its ultimate collapse created the setting for the next crisis. The CEBA was enacted to address numerous issues including the shortage of FSLIC's financial resources and its impaired ability to resolve the problems of the thrift industry.

The accounts of all savings and loan associations in Texas are insured by the FSLIC. Consequently, State Associations are subject to both State and Federal regulations. With respect to the Federal regulations, there is one body of regulations, promulgated by the FHLBB under authority of the HOLA, that primarily applies only to Federal Associations. Another set of regulations, promulgated by the FSLIC under authority of the NHA, applies to all savings institutions insured by the FSLIC. State Associations are also subject to regulations promulgated by the Savings and Loan Section of the Finance Commision and the State S&L Department (the "Texas Regulations"). All Federal and State savings institutions in Texas are members of the FHLB of Dallas. The jurisdiction of the FHLB of Dallas is the FHLBB's Ninth District which includes Arkansas, Louisiana, Mississippi, New Mexico, and Texas.

Current Status

As of December 31, 1986, there were 63 Federally-chartered and 218 State-chartered savings institutions in Texas. These 281 institutions had aggregate assets in the amount of $96,423,407,000 ($99,014,500,000 as of June 30, 1987).

The increase in the assets of State Associations between 1961 and 1986 is illustrated in Table 1. It is noted that the number of institutions increased by 35 percent between 1961 and 1986, yet, the asset growth within the same period was 1,260 percent.

TABLE I

ASSET GROWTH OF STATE ASSOCIATIONS

Year	Number of State Associations	Total Assets
1961	161	$1,751,412,000
1979	255	$23,835,730,000
1986	218	$83,144,528,000*

*At the end of 1986, Federal Associations in Texas held an additional $13,278,879,000 in assets.

According to Roy G. Green, former President of the FHLB of Dallas, 98 percent of the problems that now exist were created between 1982 and 1985. Mr. Green also observed that 95 percent of the problem institutions in Texas are State-chartered.

Deposit and asset growth in the 41 most troubled Texas Associations subject to close supervision by FSLIC (the "FSLIC Cases")[1] between 1982 and 1986 was dramatic. Between 1983 and 1986, the aggregate deposit liabilities in the FSLIC Cases increased approximately 170 percent. The national average increased during that time period approximately 65 percent. Between 1982 and 1986, asset growth for the FSLIC Cases equalled 190 percent, while the national average for the same time period was 68 percent

Table II illustrates the change in asset mix which occurred in the FSLIC Cases during this period. The FSLIC Cases moved away from traditional loans (residential mortgages) toward riskier investments. Although this trend was also evident in the national averages, the shift was not as pronounced. Also, the increase in slow loans and repossessions apparent in the FSLIC Cases did not occur nationally.

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[1]This information was furnished to the Task Force in June 1987.

TABLE II

FSLIC CASES ASSET MIX

	TEXAS FSLIC CASES		NATIONAL AVERAGE	
	1982	1986	1982	1986
Direct Investment, Acquisition, Development and Construction ("ADC") Loans	8%	34%	1%	5%
Real Estate Owned and Slow Loans	1%	38%	1%	4%
1-4 Family Residential Mortgage Loans	58%	15%	70%	55%

Table III shows the net worth status of all savings and loan associations in Texas and, separately, State Associations. This information was supplied by the FHLB of Dallas. Forty percent of State Associations are insolvent and 66 percent of State Associations fall below the required regulatory capital level of 3 percent.

TABLE III

NET WORTH STATUS

TEXAS-DOMICILED SAVINGS AND LOANS

September 30, 1987

Net Worth	Number of Institutions All Institutions	State-Chartered
Less than -5%	69	56
-5% to 0	34	29
0 to +3%	40	27
+3% to +6%	81	57
More than +6%	57	44
TOTAL	281	213

In considering these statistics, the reader should be aware that the accounting standards and practices employed by certain savings and loan associations may be maintained on a basis of Regulatory Accounting Practices ("RAP") as compared to Generally Accepted Accounting Principles ("GAAP"). The general result of such practices is that the capital amounts and capital ratios of such institutions would probably be decreased by the application of GAAP.

The insolvent institutions have not been closed by the appropriate chartering authority but remain open through

regulatory forbearance. Many are under direct regulatory control through the State Voluntary Supervisory Control ("VSC") program or other State agreement, or through the Federal Management Consignment Program ("MCP").

Under the VSC program, a Supervisory Agent appointed by the State Commissioner assumes control of the institution. There are 31 State Supervisory Agents operating 69 State Associations. Under MCP, a manager appointed by the FHLB takes over and operates the institution. Currently there are 11 MCP institutions in Texas. The high number of institutions being operated under VSC and MCP programs is largely due to the capital inadequacy of FSLIC which prevents it from liquidating these institutions. To fund their asset portfolios, the insolvent institutions must continue to compete for deposits. This has caused a significant increase in the cost of deposits for all Texas savings and loan associations (known as the "Texas Premium"; see Section VIII of this Report). Further, the 80 VSC and MCP institutions are losing approximately $4,500,000,000 per year. The ultimate cost will be borne by the United States taxpayer.

The CEBA has provided a complicated financing plan through which the capital accounts of FSLIC may be increased by as much as $10,825,000,000 over a 3-year period. No more

than $3,750,000,000 of public debt instruments issued to raise capital for this program may be sold in any one year. The net effect is that, through a combination of CEBA capital infusion and premiums paid by thrift institutions, FSLIC will have an estimated additional $15,800,000,000 available over the next 3 years. The funds will still leave FSLIC far short of the amount needed to close the exisiting insolvent savings and loan institutions. However, a judicious use of these resources may have a significant impact on alleviating the current crisis.

Status of Deposit Insurance

It is worth noting that in 1982, the 97th Congress stated that "deposits, up to the statutorily prescribed amount, in federally-insured depository institutions are backed by the full faith and credit of the United States."

In August 1987, this "sense of Congress" was reaffirmed in Section 9.01 of CEBA which provides as follows:

> SEC. _______(901) REAFFIRMATION OF SECURITY OF FUNDS DEPOSITED IN FEDERALLY INSURED DEPOSITORY INSTITUTIONS
>
> (a) Findings. The Congress finds and declares that--
>
> > (1) since the 1930's, the American people have relied upon Federal deposit insurance to ensure the safety and security of their funds in federally insured depository institutions; and
> >
> > (2) the safety and security of such funds is an essential element of the American financial system.
>
> (b) Sense of Congress. In view of the findings and declarations contained in subsection (a), it is the sense of the Congress that it should reaffirm that deposits up to the statutorily prescribed amount in federally insured depository institutions are backed by the full faith and credit of the United States.

Causes

Institutions and individuals interviewed by the Task Force basically agreed about the causes of the current difficulties in the industry. Their differences surrounded the relative importance of the various factors. The principal factors are discussed below:

1. Texas Economy. Media reports have drawn attention to the crises that have arisen in Texas affecting the financial services, real estate, agriculture and oil and gas industries. The beleaguered Texas economy has had a substantial effect on the industry. It has brought down not only the mismanaged and fraudulently managed thrifts but has caused stress in the more conservative and prudently managed institutions. Such is the nature of economic reversal.

2. Interest Rates. Historically, the savings and loan industry existed with generally stable interest rates and a competitive advantage afforded by Federal Reserve Board Regulation Q. Regulation Q controlled the interest rates that banks and thrifts could pay on deposits and granted to thrifts a slightly higher rate paying authority than that granted to banks. Thus, the thrift industry benefited from the relative security of a portfolio of long-term, fixed rate mortgages financed by short-term deposit liabilities, the costs of which were relatively stable. In the late 1970s, interest rates in the United States increased dramatically, far above the artificially low interest rate lids imposed by Regulation Q, and thrifts found themselves at a disadvantage when competing for deposits. Accordingly, a severe disintermediation of deposits began to dramatically affect the thrift as well as the banking industries.

In 1980, Congress passed the DIDMCA which phased-out the interest rate ceilings of Regulation Q. Usury rate ceilings in Texas were dramatically increased or preempted by Federal law. Additionally, FSLIC Deposit Insurance was increased to $100,000 per depositor. Because market interest rates continued to rise, the cost of thrift institution funding increased sharply. These institutions had assets which did not typically provide for adjustments in the amount of interest earned; so negative interest spreads produced substantial losses for the industry.

3. Garn-St Germain. In order to provide relief to the beleaguered thrift industry, Congress passed Garn-St Germain in 1982 which significantly expanded the loan and investment authority of savings and loans. It transformed the industry from one primarily focused on residential mortgage lending to one with more broadly based lending activities.

4. State and Federal Supervision. The agencies regulating the thrift industry, both Federal and State, were unprepared for the passage of Garn-St Germain. Staffs which for years had the relatively simple task of examining portfolios of residential mortgage loans, were ill-equipped to review complicated acquisition, development, and construction loans, land swaps, and broadly diversified investment

portfolios. In the midst of this changing environment, the Ninth District Federal Home Loan Bank (now the FHLB of Dallas) moved its headquarters from Little Rock, Arkansas. As a consequence, it lost the majority of its examiners and had to substantially restaff and retrain. The effectiveness of the examination system was further eroded and the periodic scheduling of examinations was disrupted. At the same time, in keeping with the Congressional direction, regulators were encouraging thrifts to exercise their expanded lending authority and "earn their way out" of their financial problems.

5. Coordination between State and Federal Regulators. During the 1982-1986 period in Texas, there was little cooperation between State and Federal regulators. This situation was counter-productive to resolution of the challenges facing the regulators. It now appears that the FHLB of Dallas and the State S&L Department are making progress in this area.

6. Regulatory Forbearance. During this period, FHLBB regulations permited and encouraged excessive asset growth in associations. For example, the minimum capital (net worth) requirements for savings and loan institutions have historically been low when compared to commercial banks.

Because most of the industry in its early years operated in the mutual rather than stock form, a newly created mutual thrift would not have capital. Capital was acquired through the retention of earnings from operations. The FSLIC regulations allowed institutions to build their capital to required minimum levels over a 20-year period after the grant of deposit insurance. Institutions were also allowed to use a 5-year average of liabilities to determine the base for that minimum. The FHLBB responded to the 1981-1982 savings and loan crisis by granting forbearance. Institutions were allowed to operate with lower capital levels, to count items such as appraised equity capital as regulatory capital, and to defer losses on the sale of assets. For example, an institution could increase its regulatory capital by merely increasing the book value of its premises. These factors allowed saving and loan institutions to have very high leverage ratios when compared with other financial service entities.

The discipline provided by placing one's private capital at risk is recognized as the cornerstone of responsible business practice. In too many cases, there simply was no deterrent--no monetary penalty--for failure or malfeasance. The potential fruits of success far exceeded the practically nonexistent consequences of failure. This, quite naturally

and understandably, destroyed the sense of balance needed to discourage excessive risk taking and irresponsible action.

The FHLBB responded to the developing crisis by significantly changing many of these regulations. This, however, may have been too little and too late. The regulatory capital regulation was completely revised in late 1984 to eliminate the 20-year phase-in and 5-year averaging provisions and to require increased capital for certain growth. In 1986 the regulation was further amended to provide for a faster build-up of capital and to reinforce the tie between growth and capital.

7. <u>New Investors</u>. The broad loan and investment powers granted to State Associations under State law together with the expanded powers granted to the thrift industry by Garn-St Germain and the then booming Texas economy attracted a host of entrepreneurs who were welcomed by the regulators as persons bringing new capital and progressive investment direction to the industry. Of the 11 State Associations currently under the Federal MCP, 7 were acquired between January 1, 1982 and September 1, 1983 by such entrepreneurs. These entrepreneuers transformed small residential mortgage loan associations into multi-billion dollar full-scope lenders and investors. For instance, one association

acquired in December 1982 with $120,000,000 in assets had grown to $1,347,000,000 in assets by December 1986. Many of these entrepreneurs as well as some existing savings and loans operators, began to engage in insider dealing, fraud, land flipping and an increased incidence of high risk lending and investment activities.

8. Broad State Investment Powers. The broader loan and investment powers enjoyed by State Associations have contributed to the current plight of the industry. Three areas which are important to understanding the current crisis are equity risk investments (this includes authority to directly invest in real estate or corporate obligations or to invest in or own subsidiary or service corporations), commercial real estate and commercial loans, and the enlargement of powers provision.

a. Equity Risk Investment Authority. An equity risk investment is defined as an ownership or risk position which places the institution at a greater risk than that resulting from being a consumer or single family residential lender. Because these investments are inherently more risky than other activities, depository institutions have either been severely restricted or entirely prohibited from making such investments. For

example, the authority of both State and Federal Associations to invest directly in corporate obligations is tightly restricted. However, a State Association's authority is much broader than a Federal Association's with respect to real property investments. Federal Associations are limited to property which is utilized as office facilities for the thrift institution; but, State Associations may directly invest in real estate in an amount up to 100 percent of their net worth.

Ownership of and investment in subsidiary corporations are included within the term equity risk investment. Both Federal and State Associations are provided with the authority to own such corporations under their respective governing statutes. Federal Associations are permitted to invest up to 3 percent of their total assets in service corporations. Of this amount, one-third must be in corporations engaged in community related activities. The service corporations of Federal Associations are authorized under FHLBB regulations to engage in a variety of activities; however, most of the activities are related to mortgage lending or investment. By contrast, State Associations may invest an amount equal to 10 percent of their assets in subsidiary corporations. Investments exceeding 10

percent of assets may be made with the approval of the State Commissioner. Such subsidiary corporations may engage in activities that are specifically listed in the regulations and in any other activity which the State Commissioner approves. The authority of the State Commissioner to approve investments in excess of 10 percent of assets, to approve each investment in a subsidiary, and to approve activities other than those listed in the regulation, was intended to provide control over the State Associations' subsidiary corporation investments and activities. However, several State Associations made substantial investments in subsidiary corporations engaged in such diverse and unrelated activities as a California automobile dealership, a real estate brokerage firm, and a motion picture producer (of one or more feature-length films). Also, subsidiary corporations of State Associations may leverage against their net worth at a ratio of twenty to one.

b. Commercial Real Estate and Commercial Loans. Another area in which State Associations have more expansive investment authority than Federal Associations is in the ability to make commercial real estate and commercial loans. State Associations have no asset limitation on the amount of loans they can secure by

commercial, nonresidential real estate. Also, there is no limit on the amount of commercial non-real estate loans (working capital or oil and gas loans, for example) that State Associations can make. Federal Associations must limit their commercial non-real estate loans to 10 percent of assets and their commercial real estate loans to 40 percent of assets.

Of particular concern in this area are acquisition, development and construction loans ("ADC loans"). These are loans to finance the purchase of real estate, the development of property, and the construction of improvements. In certain instances, a lending institution would make an ADC loan to a borrower/developer who had little or no invested equity in the real estate, would take a profit or equity participation in the project, and would provide the interest carry for the loan. This type of ADC loan put the lending institution in a position of assuming virtually all of the risk of the project. State Associations had broader commercial real estate lending authority than Federal Associations and, thus, had a higher volume of commercial ADC loans. The downturn in the real estate market caused many of these loans to become real estate owned or problem credits.

Both Federal and State Associations have been subject to limitations on nonresidential investments imposed by the Internal Revenue Code of 1954, as amended. To qualify for beneficial tax treatment (the bad debt deduction), thrift institutions were required to have at least 60 percent of their assets in qualifying assets. The list of qualifying assets, however, contained not only residential mortgage loans but also certain governmental securities, office property and other assets. The reduction of the tax benefit provided by the Federal income tax laws will erode the effectiveness of the qualifying asset limit.

The CEBA includes a provision that requires thrift institutions to maintain 60 percent of their assets in qualifying assets to continue to obtain full access to the Federal Home Loan Bank Advance program and to allow parent holding companies to engage in non-thrift related activities. The CEBA list of qualifying assets, however, is broad and may not work to constrain nonresidential investments such as commercial real estate loans.

c. Texas Enlargement of Powers Provision. In Section 5.05, the Texas Savings and Loan Act states:

> Notwithstanding any provision of this Act to the contrary, an association may make any loan or investment, perform any function, or engage in any activity permitted a Federal Association domiciled in this state.

This provision is intended to provide competitive equality between State Associations and Federal Associations. However, more expansive Federal regulations have made a substantial contribution to the industry problems in one key area. Federal regulations permit thrifts to make real estate loans in an amount up to 100 percent of the "appraised market value" of the security for the loan. State regulations limit loans to 100 percent of the lesser of "appraised value" or "purchase price" of the security property plus the cost of improvements to the property. Many savings institutions became overly aggressive in making ADC loans based upon appraisals which reflected the fully developed and stabilized value of the property. In many cases, substantial loan proceeds to be utilized for interest reserves, excess points, and development profits were provided. The unearned interest and points could be paid out as "profit" to the institution's ownership and the developer's profits could be siphoned off prior to

completion of the project. The use of the appraised value concept without limitation has led to substantial abuses through the use of inflated appraisals based upon future development and use.

9. Appraisal System. As noted above, with the ability to make loans at 100 percent of appraised value, obtaining high appraisals became evermore important to the industry. The appraisal system in Texas is unregulated. Appraisers can be influenced by the possibility of repeat business and may be motivated to design the results of their appraisals to suit the desires of their clients. Consequently, inaccurate and inflated appraisals could be obtained in connection with lending activities.

10. Other Factors. In general, it may be fairly stated that the industry was ill-equipped to deal with the exigencies imposed by volatile interest rates, the oil industry boom and the subsequent downturn of the Texas economy. The shortage of qualified examiners and supervisors in the State and Federal agencies was reflected in a shortage of industry managers capable of handling the new and more complex lending environment. Rapid growth overcame management depth and traditional underwriting standards could not cope with the complexities produced by the new generation of deal-makers.

Further, during the period when recapitalization of FSLIC was being addressed by Congress, there were many other legislative considerations, political pressures and posturing which impacted the timeliness of the legislative process. These factors delayed the passage of the required legislation. Meanwhile, the situation in the industry continued to deteriorate.

II

SUPERVISION OF STATE-CHARTERED SAVINGS AND LOAN ASSOCIATIONS BY THE STATE OF TEXAS

The Task Force finds that the State system of supervision and examination of State Associations is inadequate. The State S&L Department, like its Federal counterpart, the FHLB of Dallas, was unprepared for the deregulation of the industry brought about by the DIDMCA and Garn-St Germain. Since its move to Dallas, the FHLB of Dallas has been able to substantially strengthen its supervision and examination capabilities. Unfortunately, the capabilities of the State S&L Department have remained relatively weak. The reasons for this are several fold:

1. Appropriations Process For State S&L Department. The most obvious and direct reason for the State S&L Department's weakness is the inadequate funding of the Department. All of the State S&L Department's expenses are funded through the fees and charges collected by the Department from the savings and loan industry. Prior to September 1, 1985, the State S&L Department, the Texas Banking Department and the Office of Consumer Credit each

managed its own income and the Finance Commission approved their annual budgets. Now, this revenue must be deposited in the State Treasury and, as a consequence, becomes subject to the legislative appropriation process. Over the past two years, the Legislature has drawn on these revenues to provide monies to the State General Revenue Fund. This has the effect of taxing an already weak industry and prevents the State S&L Department from properly regulating its institutions.

Since the State S&L Department is subject to the legislative appropriations process, all personnel in the examination staff are subject to the pay limitations imposed by the State position classification system. State examiners are inadequately compensated relative to their private industry and Federal counterparts (see Table IV). This makes recruitment and retention of experienced personnel virtually impossible. Unless the current pay limitations are lifted, any improvement in the quality of the State examination system is unlikely.

TABLE IV

COMPARISON OF STATE AND FEDERAL EXAMINERS

	Federal (Ninth District)	State
Number of Examiners	251	42
Number of Institutions	490	218
Approximate Ratio Institutions:Examiners	2:1	5:1
Annual Salary		
Minimum	$20,408	$18,180
Maximum	$69,118	$45,648
Average	$31,743	$26,767*

*40 percent of State Examiners make less than $20,000 per year.
80 percent of State examiners have less than 4 years experience.

2. Composition of the Savings and Loan Section of the Finance Commission.[2] Under Texas law, the Savings and Loan Section of the Finance Commission is responsible for over-seeing the activities of the State S&L Department, promulgating its rules and regulations, and electing (with the joinder of three other membrs of the Finance Commission) the Savings and Loan Commissioner.

[2]The Finance Commission is established by the Texas Banking Code and consists of twelve (12) members divided into three (3) sections; The Banking Section, consisting of six (6) members, The Savings and Loan Section, consisting of three (3) members, and the Consumer Credit Section, consisting of three (3) members.

The Savings and Loan Section consists of three members, two of whom must be full-time employed executives of State Associations. This requirement insures industry domination of the regulatory and administrative processes. In addition to promulgating general rules and regulations governing State Associations, two of the members of the Savings and Loan Section must be among the five affirmative votes of the Finance Commission required for electing the State Commissioner. The Task Force believes that the interest of the public would be better served by a regulatory agency that was not dominated by representatives of the regulated entities.

3. <u>Method of Selection and Compensation of the Savings and Loan Commissioner</u>. State law provides that the State Commissioner is elected by the Finance Commission with the advice and consent of the Senate. According to Article 342-205(a) of the Texas Banking Code, the pool of candidates for this process is limited to those who have

> . . . not less than five (5) years practical experience within the ten (10) years prior to his election in the executive management of a savings and loan association doing business in this State, provided that experience as Savings and Loan Supervisor, Deputy Savings and Loan Supervisor, Savings and Loan Examiner, or Savings and Loan Hearing Officer shall be deemed savings and loan experience within the meaning of this Section.

By definition all FHLB employees, FSLIC employees, FDIC employees, experienced out-of-state savings and loan executives or regulators, experienced attorneys and Certified Public Accountants in the financial services industry, and many other categories of businessmen and professionals are excluded from consideration. This type of parochial limitation does not exist with other state regulatory authorities such as the Railroad Commission, the Public Utility Commission, the Water Commission and the Insurance Commission. For instance, the qualifications for the Texas Banking Commissioner require only that he "have not less than ten (10) years experience in banking or bank supervision."

A further obstacle to attracting qualified State Commissioner candidates is the existing salary cap. By law the State Commissioner may not receive a salary in excess of that paid to the Governor. The State Commissioner, who regulates an industry with approximately $83,000,000,000 in assets, currently earns a salary of $77,250 whereas his Federal counterpart, the President of the Federal Home Loan Bank of Dallas, earns approximately $200,000 ("American Banker," January 19, 1987). It is difficult to attract qualified individuals to this position while the salary remains uncompetitive.

TASK FORCE RECOMMENDATIONS

The Task Force makes the following recommendations:

1. The funding of the State S&L Department should be removed from the legislative appropriations process. The State S&L Department is and can continue to be self-sustaining through the fees and other revenues it collects. By removing the State S&L Department from the appropriations process, the salaries of examiners will be made competitive with those offered by private industry and Federal agencies.

2. The membership of the Savings and Loan Section of the Finance Commission should be increased to five. Only two of the five-member Section should be required to be full-time executives of State Associations. The remaining three members should qualify on the basis of recognized business ability.

3. The Texas Banking Code Article 342-205(a) should be amended to include the consideration of all individuals with "demonstrated experience with regulated financial institutions" whether in-state or out-of-state. This would encompass those with experience as State or Federal regulators as well as attorneys, Certified Public Accountants, and other

professional consultants with similar experience. If there can be demonstrated some public benefit in the imposition of any restrictions for service as State Commissioner, such restrictions should be sufficiently broad so as to allow a reasonable universe of qualified candidates from which to choose.

4. The existing salary cap for the State Commissioner should be removed.

III

LOAN AND INVESTMENT POWERS OF STATE CHARTERED SAVINGS AND LOAN ASSOCIATIONS

The heart of the Texas savings and loan problem lies with the Texas economy, exacerbated in some cases by inadequate supervision, questionable underwriting practices, poor management and insider abuse. The Task Force believes that certain lending and investment powers have also contributed to the industry's problems. Regulations concerning equity risk investments and commercial real estate and commercial loans have put the industry at greater risk. Further, the enlargement of powers provision has reduced the flexibility of the State regulatory system.

Both State and Federal regulatory agencies have recognized the adverse affects which have resulted from these areas. In 1985, the Texas Act was substantially rewritten and the FHLBB added regulations which limited equity risk investments. The revisions to the Texas Act primarily affected the powers of the State Commissioner, particularly his authority to supervise and control a State Association. The revisions also provided the State Savings and Loan Section of the Finance Commission with general authority to regulate the lending and investment powers of

State Associations. More explicit rules for various types of loans were provided, including a provision limiting the amount of interest carry in a loan. State Associations are still authorized to make any loan or investment they could make were they Federal Associations. The changes in the Texas Act and the State regulations occurred at the same time the industry crisis peaked. Thus, it is too early to determine whether these changes will sufficiently control the operations of State Associations and minimize the types of problems which are now evident.

In early 1985, the FHLBB promulgated regulations to limit equity risk investments. These regulations placed a 10 percent of asset cap on the total amount invested by an association in subsidiary corporations and direct investments (including real estate). Amounts above the cap are permissible with approval from the Federal Home Loan Bank. In early 1987, the FHLBB significantly altered the formula for determining permissible levels of equity risk investments by tying investment levels to an association's tangible capital. For those institutions which have tangible capital equal to or exceeding 6 percent of total liabilities, 3 times tangible capital may be invested without prior approval. For those institutions which meet the minimum requirements but have tangible capital of less than 6

percent, $2\frac{1}{2}$ times tangible capital may be invested without prior approval. Tangible capital is defined for purposes of the equity risk investment regulation as the sum of equity capital plus subordinated debt approved for inclusion as regulatory capital minus goodwill. The items defined as equity investments were expanded to include land and non-residential construction loans with loan-to-value ratios exceeding 80 percent. This revision should limit the exposure of the thrift industry to equity risk investments.

TASK FORCE RECOMMENDATIONS

The Task Force makes the following recommendations:

1. The State S&L Department must vigorously enforce the lending and investment regulations to insure that State Associations make investments that "are consistent with sound lending practices and . . . promote the purposes of the Texas Act."

2. The State S&L Department should cooperate with the FHLB of Dallas to insure that State Associations comply with the equity risk investment regulation.

3. If the new State and Federal regulatory provisions do not effectively limit the equity risk investments of

State Associations, serious consideration should be given to changes in either the Texas Act or regulations so as to provide effective limitations.

4. The Texas Act should be amended to provide the Savings and Loan Section of the Finance Commission, rather than the State Commissioner, with the authority to approve subsidiary corporation activities which are not explicitly listed in the regulations.

5. The Task Force recognizes that the Texas Act and the enlargement of powers provision (Section 5.05) are designed to make the Texas savings and loan charter attractive. This is an important consideration as regulatory agencies seek to resolve the problems facing the industry. However, Section 5.05 of the Texas Act can compromise efforts to regulate lending and investment through State regulation. Consideration should be given to limiting this Section by providing that the scope of the Section could be restricted by express provision of the Savings and Loan Section of the Finance Commission.

IV

STATE SAVINGS AND LOAN EXAMINATION PROCESS

Examination of State Associations is currently performed by both the State S&L Department and the FHLB of Dallas. Examinations are designed to review the financial condition, operations, lending and investment practices of the institution, to determine compliance with applicable laws and regulations, and to determine whether safe and sound lending and investment practices are being followed. In the past year, the FHLB has been able to substantially improve the quality and number of Federal examiners. Regulators and industry representatives agree that legislatively imposed limits on access to available resources at the State level have prevented the State S&L Department from developing and retaining a staff capable of comprehensive and high quality examinations.

Given the obvious duplication of effort resulting from two independent examination staffs and the inadequate resources available at the State level, it has been suggested that the State examination system be eliminated. The Task Force, however, believes that the State should not abdicate the supervision and examination of State Associations to

Federal authorities, but should shoulder its own responsibilities in this area.

TASK FORCE RECOMMENDATIONS

The Task Force makes the following recommendations:

1. The State Commissioner should work with the FHLB of Dallas to thoroughly coordinate the State and Federal examination processes. Particular attention should be directed to the maximum feasible use of joint examinations.

2. Unless and until sufficient State funding is available and a better staffed State examination force is established, the State Commissioner should consider the following:

(a) Limiting State examinations to problem areas identified by the FHLB examinations.

(b) Limiting State examinations to certain targeted areas such as State Associations exhibiting excessive asset growth or Associations with a weak capital base.

(c) Focusing State examinations on areas where State laws and regulations differ from Federal laws and regulations.

3. The State S&L Department should employ an independent consultant to institute procedures for the examination of State Associations, to facilitate coordination of the Federal and State examination efforts, and to establish guidelines for effective utilization of the existing State examination staff (assuming additional funding is not made available).

V

CHANGE OF CONTROL

Prior to September 1, 1983, Texas law did not provide the State Commissioner with authority to approve changes in the control of State Associations. Since September 1, 1983, the State Commissioner has been presented with 79 applications for change of control and has approved 53 of those applications. According to the State Commissioner, 19 of those institutions are currently insolvent.

The State S&L Department has suggested that the approval process constrains the State Commissioner's disapproval of a change of control by placing the legal burden of proof on him (Section 11.20(d) of the Texas Act). The State Commissioner must make an affirmative finding that the applicant does not possess sufficient qualifications to warrant a change of control. Shifting the burden to the applicant to prove that he does meet the applicable statutory criteria would substantially enhance the State Commissioner's ability to deny undesirable and unproven applicants.

TASK FORCE RECOMMENDATION

The Task Force makes the following recommendation:

1. Section 11.20(d) of the Texas Savings and Loan Act should be amended to place the burden of proof of meeting the applicable statutory criteria upon the applicant.

VI

CRIMINAL LAW ENFORCEMENT

The current industry crisis has been exacerbated by abuse and fraud perpetrated by a few savings and loan owners, operators, and borrowers. Although some indictments have been returned, they have been extremely slow in forthcoming. For instance, the FBI began investigating the Empire Savings and Loan Association catastrophe in October 1983. It was not until October 1987 that indictments were issued against the persons alleged to have caused the failure of the institution. A more timely pursuit of criminal enforcement action in the Empire case may have prevented some of the abuses that are currently under investigation.

Extensive Federal statutes provide adequate means of prosecuting persons involved in abuse of financial institutions. Prior to the adoption of Section 11.17 of the Texas Act, which became effective on August 27, 1985, Texas criminal statutes defined few offenses specifically related to financial institutions. Section 11.17 now makes it a felony, punishable by a fine of not more than $100,000 and imprisonment for not more than ten years, 1) to knowingly destroy or conceal records of an association, 2) to make

false statements or reports to an association, to the State Commissioner or to the State S&L Department or 3) to over-value property in connection with a transaction with an association for the purpose of influencing the actions of an association, the Savings and Loan Section of the Finance Commission, or the Office of the State Commissioner.

The authority to prosecute violations under the State law lies with the local District Attorneys. The District Attorneys are hampered by modest investigative staffs and minimal support personnel. Consequently, unless they are furnished with extensive documentation of the offense by the referring agency, State District Attorneys are reluctant to pursue complex cases involving new statutes which are not a part of the Penal Code and have not been judicially interpreted. As of June 1987, no referrals had been made to the District Attorneys under Section 11.17 by the State S&L Department. All suspected criminal activity has been referred to Federal prosecutorial authorities.

At the same time Section 11.17 was adopted, the legislature added Section 11.23 to the Texas Act. This Section authorizes the State Commissioner to bring a derivative suit on behalf of a State Association if he determines that the institution has an unpursued cause of action and

that the protection of the interests of the institution, its shareholders, members, or creditors, or the interest of the public requires that suit be brought. To date this Section has not been used by the State Commissioner.

In August 1987, a Federal Texas Task Force was established as a result of meetings and discussions between the FHLB of Dallas, FBI, U.S. Attorney and U.S. Department of Justice. This task force was charged with responsibility to investigate and prosecute crimes against financial institutions located in the Northern Judicial District of Texas. The Federal task force consists of two Assistant U.S Attorneys; five and one-half fraud-section trial attorneys from Washington; twenty-five FBI agents; five IRS Agents; and four Officials of the FHLB of Dallas together with substantial support personnel. The Federal task force is making substantial progress and has received support from the State S&L Department.

Both State and Federal regulatory agencies indicated that current State and Federal statutory sanctions are sufficient to bring justice to those who have abused and to deter those who may abuse financial institutions in Texas.

TASK FORCE RECOMMENDATIONS

The Task Force makes the following recommendations:

1. The State S&L Department should develop the staff necessary to provide adequate assistance to the Federal and State law enforcement and prosecutorial agencies responsible for addressing criminal violations. Naturally, such efforts are constrained by the availability of adequate funding.

2. The State Commissioner should establish procedures to insure that derivative suits seeking civil damages or restitution are instituted against insiders upon the discovery of self dealing, gross mismanagement or fraud.

VII

VOLUNTARY SUPERVISORY CONTROL PROGRAM OF THE TEXAS SAVINGS AND LOAN DEPARTMENT

The Texas Act authorizes the Commissioner to initiate various enforcement actions. The most frequently used enforcement power of the State Commissioner and the State S&L Department since 1985 has been Voluntary Supervisory Control ("VSC"). The Texas Act permits the board of directors of an association to consent to the placement of the association under the supervisory control of the State Commissioner. The State Commissioner is authorized to appoint a supervisor ("Supervisory Agent") and one or more deputy supervisors. The Supervisory Agent is endowed with the powers of a conservator under Section 8.08 of the Texas Act and with such other powers as may be established by agreement between the State Commissioner and the subject association's board of directors. By statute, supervisory control continues until the problems which were the basis for the initiation of supervisory control are corrected. Costs of supervisory control are fixed by the State Commissioner and paid by the subject association.

The 69 State Associations currently under VSC own assets of approximately $19,000,000,000 and show approximately

$3,500,000,000 of negative net worth. These institutions are losing an estimated $3,000,000,000 per year. It is anticipated that additional institutions will be placed under VSC in the near future.

The VSC program is a useful and extremely important tool in the State's enforcement and rehabilitation program. It has been criticised due to the actions and performance of some of its Supervisory Agents. There are no required qualifications for Supervisory Agents. Further, there are no policies or guidelines for the Supervisory Agents to employ in conducting the daily operation of their institutions.

TASK FORCE RECOMMENDATIONS

The Task Force makes the following recommendations:

1. The State S&L Department should establish minimum qualifications for a Supervisory Agent.

2. The State S&L Department should establish formal operating guidelines for the Supervisory Agents. Procedures should be standardized to insure uniform treatment of the savings and loan associations subject to supervisory control.

3. The State S&L Department should attempt to coordinate the activities of the Supervisory Agent with the supervisory personnel at the FHLB of Dallas. The savings and loan associations subject to VSC are invariably subject to some enforcement action initiated by the FHLB of Dallas, which, at a minimum, restricts the operation of the subject institution. Consequently, an expansion of power for the Supervisory Agent at a subject association may not be effective in facilitating its management, given the constraints of federal enforcement action. The State S&L Department and the FHLB of Dallas should attempt to formalize an arrangement whereby the FHLB of Dallas authorizes the Supervisory Agent to approve matters and transactions on behalf of the FHLB of Dallas. This procedure has been utilized on a very limited basis.

VIII

INDUSTRY RECOVERY: COST OF FUNDS AND CONSOLIDATION

There exist a significant number of hopelessly insolvent institutions which remain open under various forms of regulatory supervision. Critical decisions and actions regarding these institutions and their assets have become mired in the everchanging interplay between Supervisory Agents, management consignees, FSLIC, FADA and new and reconstituted Boards of Directors. While these institutions pay high rates for their liabilities, their assets produce less income and incur greater expense through the legal, accounting, and consulting fees mandated by the supervisory policies.

A principal source of funds for State Associations is the purchase of deposits in the national markets. Due to the widespread knowledge of the severity of the savings and loan problems in Texas, all State Associations are required to pay a premium for these deposits (the "Texas Premium"). The Texas Premium arises due to the concern of many depositors that even though FSLIC will honor its deposit guarantee, delays without interest compensation or a reduction of

the contract interest rate may occur. Table V illustrates the Texas Premium.

TABLE V

AVERAGE COST OF FUNDS AS A PERCENTAGE OF AVERAGE ASSETS OF SAVINGS AND LOAN ASSOCIATIONS*

Year	United States	Texas
1981	9.95	10.32
1982	10.40	10.55
1983	9.22	9.30
1984	9.51	9.70
1985	8.56	8.91
1986	7.42	8.00
1987 (through March 31)	6.54	7.20

*From the Texas Savings and Loan League Special Issues Commission, "Report on the Texas Thrift and Real Estate Crisis," October 30, 1987.

New capital must be attracted to the system to fuel the industry's recovery. Additionally, every effort should be made to minimize the caretaking expenses of institutions that are ultimately nonviable.

TASK FORCE RECOMMENDATIONS

The Task Force makes the following recommendations:

1. Consolidated funding programs which obtain funds outside the Texas market for use by Texas thrifts should be

established or expanded. The FHLB of Dallas' "As Agent" program allows stronger savings associations throughout the nation to provide funds to the FHLB of Dallas which then makes them available to troubled institutions in the Ninth District. This program and programs for pooling brokered funds should be aggressively encouraged.

2. The FHLBB should act with all due diligence in soliciting, considering and awarding bids by new capital sources for existing thrifts. Nonviable thrifts should be "packaged" with creative FSLIC financial and regulatory assistance to create marketable entities. The current efforts of the FHLBB in this area are applauded.

3. Viable institutions which possess adequate management ability and acceptable capital and business plans should be considered for immediate merger opportunities with nonviable institutions. Consideration should be given to effecting consolidations on a regional basis to allow for administrative efficiencies.

4. The State Commissioner should provide assistance to the FHLBB in connection with the coordination of mergers and acquisition groupings.

IX

MANAGEMENT AND DISPOSITION OF NON-PERFORMING LOANS AND REAL ESTATE OWNED

The ultimate loss to most Texas savings and loans and the FSLIC fund will be determined by the quality and timeliness of decisions pertaining to real estate. The bulk of problem assets are currently in non-performing real estate loans and foreclosed real estate. Professional management of these assets is essential to achieving the best values. Criticism has been leveled at the existing supervisory system (whether MCP, Supervisory Agent, FSLIC or FADA) which incurs high costs and prevents timely asset disposition.

TASK FORCE RECOMMENDATIONS

The Task Force makes the following recommendations:

1. Through the consolidation process discussed in Section VIII of this Report, as much real estate as possible should be placed in the hands of those with the authority and incentive to manage it properly.

2. A coordinated plan should be developed by the State Commissioner, FHLB of Dallas, FSLIC and FADA for the

management and disposition of those assets which cannot be transferred to new ownership through merger or acquisition. The plan for real estate disposition should include a prudent time frame to prevent a general depression of market values.

3. Consideration should be given to a "clearing house" for identifying and marketing real estate assets. This would facilitate the search for properties by outside investors.