APPENDIX 2

THE FAILURE OF MADISON GUARANTY AND THE SAVINGS & LOAN CRISIS OF THE 1980s AND 1990s

The investigation and criminal prosecutions spawned by the operation and collapse of Madison Guaranty was, in many ways, representative of what occurred throughout the United States savings and loan industry during the 1980s and early 1990s, when banks and thrifts were failing at a rate not previously seen since the Great Depression in the 1930s.[1] The crisis became so well known that it earned its own title in the media, "the S&L debacle," a phrase that the Federal Deposit Insurance Corporation ("FDIC") adopted.[2] Joseph Neely, the Director of the FDIC, emphasized the widespread bank failures during the period when he said, "Over a 15-year period from 1980 to 1994, a federally insured depository institution failed on an average of every other day."[3] At the height of the crisis, Director Neely continued, a bank or savings institution failed every day. In a single day, institutions holding one-third of the banking assets in New Hampshire closed.[4] In contrast, Neely noted in April 1998 that "[l]ast year, no thrift failed and no thrift has failed in the last 21 months."[5] The total amount of assets held in the 1,295 savings and loan institutions like Madison Guaranty that failed from 1980 to 1994 was $621.2 billion.[6]

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[1] Federal Deposit Insurance Corporation, The FDIC and RTC Experience: Managing the Crisis at 4 (Vol. 1 Aug. 1998) (noting the parallels between the number of banks closed and assets involved between the two periods).

[2] Federal Deposit Insurance Corporation, History of the Eighties -- Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s at 167 (Dec. 1997).

[3] Id.

[4] Joseph Neely, FDIC Director, Luncheon Address (Apr. 29, 1998), reprinted in Federal Deposit Insurance Corporation, The FDIC and RTC Experience: Managing the Crisis at 41 (Vol. 2 Aug. 1998).

[5] Id.

[6] Federal Deposit Insurance Corporation, The FDIC and RTC Experience: Managing the Crisis at 29 (Vol. 1 Aug. 1998) (Chart I.1-5 "Failed Bank and S&L Assets 1980-1994"); id.

By 1990, the staggering cost of the S&L debacle was being measured in the clean-up costs that would be borne by every single American household. In May 1990, U.S. Secretary of the Treasury Nicholas F. Brady testified that more than 1,000 savings and loan associations, or forty percent of the industry, would have to be seized by the government at a cost of at least $89 billion to $130 billion, or $1,300 for every American household.[7] Secretary Brady's prediction was dwarfed by that of Charles A. Bowsher, the Comptroller General, who told Congress in the spring of 1990 that "including interest payments, the bailout would cost at least $325 billion, probably much more and possibly as much as $500 billion in the next [forty] years, or $5,000 for each American household."[8] As of December 31, 1995, the costs for cleaning up the savings and loans that failed from 1980 to 1994 stood at $161.40 billion.[9]

The proportional clean-up costs imposed on the American taxpayer by failed Arkansas savings and loans like Madison Guaranty were among the nation's highest. Arkansas had the third highest ratio of resolution costs to savings and loan assets at resolution, or percentage of bail-out costs funded by the American taxpayer that could not be recovered through the failed

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at 795 (Chart C.2 "Number of S&L Failures 1980-1994"); id. at 798 (Chart C.5 "Failed S&L Assets 1980-1994"). A two page chart of Madison Guaranty "Net Worth Comparisons" is attached to this appendix. The chart was prepared by the Office of the Independent Counsel based on Madison Guaranty monthly, quarterly, and semi-annual reports submitted to the FHLBB.

[7] David E. Rosenbaum, The Savings Debacle: A Special Report: A Financial Disaster with Many Culprits, N.Y. Times, June 6, 1990, at A1.

[8] Id.

[9] Federal Deposit Insurance Corporation, The FDIC and RTC Experience: Managing the Crisis at 808 (Vol. 1 Aug. 1998) (Chart C.17 "S&L Resolution Costs by Year of Failure 1980-1994").

institution's own assets, in the nation, exceeded only by failed institutions in Guam and Texas.[10] For every depositor dollar that had to be covered due to the collapse of an Arkansas savings and loan, 60.44 cents had to be funded by the government because of the deficiency in the value of the remaining assets.[11] The national average was 25.98 cents.[12]

Just as Madison Guaranty's failure was entirely ordinary, so were the causes. The speculative commercial real estate loans and insider fraud found to exist at Madison Guaranty and among its principals and associates were also described as primary causes of failures throughout the thrift industry. L. William Seidman, a former Chairman of both the FDIC and Resolution Trust Corporation ("RTC"), said that "fraud had been found in [sixty] percent of the failed savings institutions and that in half of those, it had been the main element in the institution's demise. Phony appraisals, self-dealing, loans to family and associates, kickbacks and payoffs were rife."[13] The prevalence of fraud was not just Seidman's opinion. "In July 1993, a national commission . . . reported to the president and Congress . . . that there had been 'unprecedented fraud and abuse' by persons connected with failed institutions, although that was not the sole cause of the crisis, and that 'fraud and misconduct were important elements in the savings and loan (S&L) debacle.' The national commission found a 'continuum of abusive practices' ranging from aggressive search for regulatory loopholes to outright fraud by failed

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[10] Id. at 856 (Table C.11 "S&L Failures by Location Ranked by Resolution Costs/S&L Assets 1980-1994).

[11] Id.

[12] Id. at 857.

[13] David E. Rosenbaum, The Savings Debacle: A Special Report: A Financial Disaster with Many Culprits, N.Y. Times, June 6, 1990, at A1.

institution managers, attorneys, accountants, appraisers, and others. Noting that 'estimates of the actual dollar losses due to fraud and misconduct differ widely,' the national commission concluded 'that taxpayer losses due to fraud were large, probably amounting to [ten to fifteen] percent of total net losses.'"[14]

With fraud rampant, bank regulators routinely referred suspected criminal activity to appropriate authorities for additional investigation and prosecution as appropriate. According to the FDIC, during investigations conducted by bank regulatory agencies, "investigators and attorneys are alert to any evidence of possible criminal wrongdoing. Whenever appropriate, they make criminal referrals to the Justice Department and the FBI. From the 1980s to the early 1990s, many thousands of such referrals were made. After FIRREA's enactment,[15] the FDIC and the RTC set up offices and criminal units dedicated specifically to facilitating the cooperative effort begun by interagency bank fraud working groups."[16]

And just as referrals relating to Madison Guaranty led to the criminal investigations, prosecutions, and convictions discussed in this Final Report, other less publicized referrals did as well. From October 1, 1988 to March 31, 1997, the Department of Justice brought 1,259

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[14] Federal Deposit Insurance Corporation, The FDIC and RTC Experience: Managing the Crisis at 267-68 (Vol. 1 Aug. 1998) (quoting National Commission on Financial Institution Reform, Recovery, and Enforcement, Origins and Causes of the S&L Debacle: A Blueprint for Reform, at ix, 3, 8, 14, 69-71 (July 27, 1993)).

[15] "When Congress passed the landmark Financial Institutions Reform, Recovery, and Enforcement Act of 1989, its primary intent was to address the financial crisis facing the thrift industry, which at the time, included some 600 seriously troubled savings associations with assets of about $350 billion." Federal Deposit Insurance Corporation, The FDIC and RTC Experience: Managing the Crisis at 743 (Vol. 1 Aug. 1998).

[16] Id. at 283-84.

indictments charging 1,955 defendants with "major" crimes relating to federally regulated savings and loans like Madison Guaranty.[17] The Justice Department obtained the convictions of 1,690 of those defendants, achieving a conviction rate of 93.2%.[18] Of those convicted, 1,149 were sentenced to terms of imprisonment.[19]

One of the other causal factors contributing to thrift failures identified by the FDIC, which was also one of the prevailing problems at Madison Guaranty, was speculative commercial real estate lending:

> Commercial real estate development is inherently risky, partly because of the long gestation period of many commercial construction projects. When completed projects finally come to market, demand conditions may have changed considerably from what they were at the time of conception. . . .
>
> In the early 1980s, booming activity in commercial construction was supported by rapidly increased bank and thrift commercial mortgage lending. . . .
>
> During the 1980s, when total real estate loans of banks more than tripled, commercial real estate loans nearly quadrupled. . . . A pervasive relaxation of underwriting standards took place, unchecked either by the real estate appraisal system or by supervisory restraints. Overly optimistic appraisals, together with the relaxation of debt coverage, of maximum loan-to-value ratios, and of other underwriting constraints, meant that borrowers frequently had no equity at stake, and lenders bore all of the risk.
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> Overbuilding occurred in many markets, and when the bubble burst, real estate values collapsed. . . . At many financial institutions loan quality deteriorated significantly, and the deterioration caused serious problems. . . .

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[17] U.S. Dep't of Justice, <u>Attacking Financial Institution Fraud</u>, Fiscal Year 1997 (Second Quarterly Report) at 3. "Major" was "defined as (a) the amount of fraud or loss was $100,000 or more, or (b) the defendant was an officer, director, or owner (including shareholder), or (c) the schemes involved multiple borrowers in the same institution, or (d) [the] case involved other major factors." <u>Id.</u>

[18] <u>Id.</u>

[19] <u>Id.</u>

> [B]anks that failed in the 1980s had higher ratios of commercial real estate loans to total assets than surviving banks. Failing banks also had higher ratios of commercial real estate loans to total real estate loans, or real estate charge-offs to total charge-offs, and of nonperforming real estate assets to total nonperforming assets.[20]

Former FDIC and RTC Chairman L. William Seidman was even more emphatic in pointing the finger of blame for the thrift industry's problems at real estate speculation:

> The critical catalyst causing [financial] institution disruption around the world can be almost uniformly described by three words: real estate loans. In the U.S., the problem was made even worse by allowing S&Ls to make commercial real estate loans in areas they knew little about. They were already in trouble because they borrowed 'short' and lent 'long' in financing the housing market.[21]

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[20] Federal Deposit Insurance Corporation, History of the Eighties -- Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s at 26-27 (Dec. 1997).

[21] L. William Seidman, The World Financial System: Lessons Learned and Challenges Ahead (Tokyo Sept. 18, 1996), reprinted in Federal Deposit Insurance Corporation, History of the Eighties -- Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s at 58 (Dec. 1997).