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Lincoln Savings and Loan Scandal: A Case Study of State-Corporate Crime

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LINCOLN SAVINGS AND LOAN SCANDAL: A CASE STUDY OF STATE-CORPORATE CRIME

by

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This thesis elaborates on the nature and scale of state-corporate crime in the *Lincoln Savings & Loan Scandal*. It provides an account of a political history of the savings and loan industry, the effect of economic deregulation, and the Garn-St. Germain deregulation legislation in the 1980s, which produced the criminogenic (conducive to crime) environment in the savings and loan industry.

This case study supports the hypothesis that criminal behavior at the organizational level results from a coincidence of pressure for goal attainment, availability and perceived attractiveness of illegitimate means, and an absence of effective social control. Therefore, the *Lincoln Savings & Loan Scandal* represents an example of state-corporate crime in which the pursuit of profit by a corporation along with the failure of state agency to effectively monitor Lincoln Savings & Loan Association, which resulted in a host of criminal activities. Thus, given an integrated theoretical framework, an analysis of state-corporate crime can be integrated through three major theoretical approaches to measure the empirical support for state-corporate crime and the theoretical interpretation of organizational misconduct.

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INTRODUCTION

LINCOLN SAVINGS AND LOAN SCANDAL: A CASE STUDY OF STATE-CORPORATE CRIME

On September 19, 1990, California Authorities arrested Charles H. Keating Jr., owner and Chief Executive Officer of Lincoln Savings & Loan Association (Lincoln Savings) and American Continental Corporation (American Continental), after a California Grand Jury indicted him on eighteen counts of criminal fraud (Farnham, 1990; Greenwald, 1990). State authorities accused American Continental, a real estate development company, of defrauding 23,000 Lincoln Savings' members out of $250 million in worthless junk bonds (Day; 1993, p. 392). In December 1991, federal authorities indicted Keating on forty-two counts of securities fraud for aiding and abetting in the fraudulent sale of the worthless junk bonds (Granelli and Bates, 1991; Furlong, 1991).

Because of these indictments, the American public became aware of the full horror of the *Lincoln Savings & Loan Scandal* that devastated the small working-class community of Irvine, California. After the government seized Lincoln Savings, it was termed "the most costly financial scandal in American history" (Thomas, 1991, p. 31). It cost American taxpayers $2.5 billion (Day, 1993; Coleman, 1994).

Subsequent inquiry indicated not only did American Continental defraud Lincoln Savings' members and committed other fraudulent activities, but also an interwoven pattern of regulatory failure and policies on the part of several federal agencies and state agency played a significant role that created the conditions, which led to the scandal. These federal agencies and state agency facilitated the regulatory failure through their refusal to enforce federal and state laws and regulations at Lincoln Savings. According to the House Committee on Government Operations, serious deficiencies exist in the way the Federal Home Loan Bank Board (the Bank Board) handled the fraudulent activity at Lincoln Savings (U.S. Congress House Committee on Government Operations; 1988, p. 8). The Bank Board treated Lincoln Savings too leniently to offer any deterrence when violations occurred (U.S. Congress House Committee on Government Operations; 1988, p. 16). Therefore, the Bank Board failed to enforce the laws and regulations that would have protected Lincoln Savings' members and American taxpayers.

Furthermore, congressional records documented networks of influence between American Continental and members of Congress who received campaign contributions from American Continental with significant repercussions on the enforcement of Lincoln Savings (U.S. Congress House Committee on Government Operations; 1988, p. 16). Five United States Senators intervened on the regulatory process and delayed the seizure of Lincoln Savings from American Continental. In addition, the Bank Board moved the Lincoln Savings' oversight from San Francisco to Washington, D.C., the Bank Board's headquarters, to avoid the seizure of Lincoln Savings.

The *Lincoln Savings & Loan Scandal* and the regulatory environment that made it possible emphasize the importance of the interaction between corporations and government in the production of criminal behavior by businesses. The *technical cause* of the scandal was bank deregulation of the savings and loan industry's infrastructure in the 1980s. As a result, American Continental used sophistry to beguile Lincolns Savings' members out of their life savings. In addition, bank deregulation allowed American Continental to make a host of fraudulent investments with Lincoln Savings' federally insured funds at taxpayers' expense. Therefore, those investors and taxpayers were the victims of a series of social decisions made by several institutions. These institutions included the Bank Board, the Federal Home Loan Bank in San Francisco (FHLB-SF), the Securities and Exchange Commission (SEC), and the California Savings and Loan Commission. These organizational units pursued a pattern of actions and relations that made it possible for Lincoln Savings to remain in business and allowed American Continental to continue its fraudulent misuse of federally insured funds in a lax regulatory environment.

Kitty Calavita, Henry Pontell, and Robert Tillman have research the broader savings and loan scandal (Calavita, Pontell, and Tillman, 1990; 1991; 1992; 1997). However, this case study highlights the *Lincoln Savings & Loan Scandal*, the key roles played by economic deregulation, the Bank Board, federal regulators, and five U.S. Senators through a variety of sources such as Congressional Hearings, media accounts, articles, journals, and textbooks. In this respect, it confirms the conclusions of previous analyses of white-collar crime that emphasize the pressures associated with competition as important causal factors (Sutherland, 1949; Faberman, 1975; Wheeler and Rothman, 1982). Thus, it will examine the ways in which the interaction between a government agency (the Bank Board) and a private corporation (American Continental) interests in the savings and loan industry culminated into the *Lincoln Savings & Loan Scandal.*

Specifically, this case study will argue that the scandal represents a special category of organizational misconduct that Ronald Kramer and Raymond Michalowski termed *state-corporate crime.* State-corporate crime is illegal or socially injurious actions that occur when one or more institutions of political governance pursue a goal in direct cooperation with one or more institutions of economic production and distribution (Kramer and Michalowski; 1990, p. 3).

First, this case study will discuss the theory of organizational misconduct as regards to *state-corporate crime* in which the scandal occurred by examining the concept of state-corporate crime and other case studies of state-corporate crimes. Second, it will examine the political economic historical context of the savings and loan industry, and the federal laws and regulations as it relates to the government's home financing policy. Third, it will discuss the where deregulation went wrong context of laissez-faire economic policy, and the Garn-St. Germain Act that set the stage for failure. Fourth, it will examine the scandal by exploring the ways in which the activities of regulatory agencies intersected with the activities of American Continental and Lincoln Savings that produced the crime. Finally, this case study will examine a theoretical interpretation explaining the crimes of American Continental Corporation and the crimes of Lincoln Savings & Loan Association.

CHAPTER 1

THEORY OF ORGANIZATIONAL MISCONDUCT: STATE-CORPORATE CRIME

The Genesis of White-Collar Crime

In 1939, Edwin H. Sutherland introduced *White Collar Crime* at his presidential address to the American Sociological Association. Sutherland's concern was crime in relation to business. "The economists are well acquainted with business methods but not accustomed to consider them from the point of view of crime; many sociologists are well acquainted with crime but not to consider it as expressed in business" (Sutherland; 1940, p. 1).

Sutherland attempted to integrate these two bodies of knowledge as comparison on "crime in the upper or white-collar class, composed of respectable or at least respected business and profession," and crime in the underclass, composed of persons of underclass socioeconomic status. This comparison was "for the purpose of developing theories of criminal behavior, not for the purpose of muckraking or of reforming anything except criminology" (Sutherland; 1940, p. 1).

Ten years later, in *White Collar Crime*, Sutherland declared, "white collar-crime may be defined approximately as a crime committed by a person of respectability and high social status in the course of his occupation" (Sutherland; 1949, p. 9). Sutherland used the term white-collar crime to illustrate that person of high social status commit crime, which must be included in the study of criminal behavior (Sutherland, 1949). Thus, the concept of white-collar crime has altered the focus of crime as well as the usual traditional conception of the criminal as underclass.

This contradiction in Sutherland's work led to the study of corporate crime. The concept white-collar crime turned the attention from conventional offenses of criminologist to the study of offenses, which not had been included within the scope of criminology. Quinney suggested that an expansion of the concept of white collar crime to include all violations that occur in the course of occupational activity regardless of the social status of the offender (Clinard and Quinney, 1973). Therefore, it seems advisable to change concept from *white-collar crime* to *occupational crime.* Thus, Quinney defined occupational crime as violation of the legal codes in the course of activity in a legitimate occupation (Clinard and Quinney; 1973, p. 158).

However, the concentrations on individualistic approach does not work well when one attempt to explain the illegal behavior of an organization such as a corporation. The corporations themselves as legal entities, as well as some corporate officials who make specific decision, are criminal. However, once these systematic crimes become normal operating procedure, they are not the responsibility of any one individual in the corporation. Rather, they are corporate crimes, in which the corporation itself is criminal (Clinard and Quinney; 1973, p. 212.). Therefore, in order to understand corporate illegal behavior, it is necessary to create a macro level approach to study the social structure of organizations rather than individuals (Braithwaite, 1989; Kramer, 1982; Clinard and Yeager, 1980; Vaughan, 1992).

According to Kramer and Michalowski, there is an important insight and an important oversight within this approach. The insight is that corporate crime is a form of organizational deviance (Kramer and Michalowski, 1990). Insofar, as corporations are formal organizations, the study of corporate crime can and should incorporate the theoretical and substantive insights of organizational research (Vaughan, 1983). The oversight is the failure to recognize that since the modern corporation emerged as the basic unit of economic activity within private-production systems in the late 19th century, corporations and governments have functioned interdependent (Sklar, 1988).

In turn, the modern corporation in the United States could have not developed, nor could it function without the legal, economic, and political infrastructure provided by government (Sklar, 1988). Therefore, governments in private-production systems depend upon corporations and other economic organizations to supply necessary goods and services. They provide the economic base for individual salaries and/or corporate profits upon which governments must depend for their revenues and to make possible the fulfillment of government development and policies (Offe and Volker; 1982, p. 249).

Criminology has accepted the study of occupational and corporate crime within criminology, but the relationship between corporations and government agencies has remained on the peripheral to the study of corporate crime (Tunnell, 1993). Theory and research in the area of corporate crime has concentrated on organizational deviance within private business corporations. On the other hand, other scholars have examined crimes and malfeasance by governments, what William Chambliss terms *state-organized crime* (Chambliss; 1989, p. 183). These state-organized crimes are crimes or socially injurious actions that result as governmental organizations pursue goals that cannot be, or cannot be attained easily within the circumscribed boundaries of government's laws (Ermann and Lundman, 1992; Roebuck and Weber, 1978; Simon and Eitzen, 1993).

The Development of the Concept of State-Corporate Crime

While the literature is replete with conflicting perspectives and conclusions, a general framework for understanding white-collar crime is beginning to emerge at the state-corporate level. Traditionally, criminologists viewed crimes of the state and crimes of corporations distinct from organizational behavior. Thus, a separate body of research and theorizing developed for each of these phenomena. The connection between state and corporate goals, be they proximal or distal, some forms of organizational deviance result from the interaction between governmental agencies and private businesses (Kramer and Michalowski, 1990). Therefore, Kramer and Michalowski introduced the concept of *state-corporate crime*. They defined state-corporate crimes as follows:

> State-corporate crimes are illegal or socially injurious actions that occur when one or more institutions of political governance pursue a goal in direct cooperation with one or more institutions of economic production and distribution (Kramer and Michalowski; 1990, p. 3).

This definition indicates that governments utilize businesses in order to achieve government goals that intersect as to produce some form of social injury. Kramer used this concept of state-corporate crime to examine *The Space Shuttle Challenger Explosion* (Kramer, 1992).

The *Challenger's* study emphasizes that the disaster was the collective product of the interaction between two governmental agencies, Congress, the National Aeronautics and Space Administration (NASA), government agencies, and Morton Thiokol, Inc., the builder of the *Challenger's* solid rocket boosters, a private business corporation. The fact that NASA and Morton Thiokol had acted together to produce a serious social harm suggested that government agencies and corporations could act together to produce serious criminality (Kramer, 1992).

In another context, Kauzlarich and Kramer used the concept of state-corporate crime to examine the environmental devastations caused by U.S. Government and nuclear weapons manufactures in the production of a nuclear arsenal (Kauzlarich and Kramer, 1993). Kauzlarich and Kramer show how this institutional arrangement, guided by Cold War cultural beliefs and structural forces, both propelled and sustained by the desire for continued American capitalist expansion, resulted in massive environmental injury (Kauzlarich and Kramer, 1993).

On the other hand, Aulette and Michalowski used the concept of state-corporate crime to examine *Fire in Hamlet*, the deadly fire at the Imperial Food Products chicken processing plant in Hamlet, North Carolina, (Aulette and Michalowski, 1993). On September 3, 1991, an explosion and fire at the Imperial Food Products chicken processing plant killed 25 workers and injured 56 workers (Aulette and Michalowski; 1993, p. 174). The *technical* cause of the fire was the rupture of a hydraulic line near a deep fryer that resulted in a fireball that swept through the chicken processing plant. However, it became clear that the company routinely locked several of its fired doors, sealing off potential exits from the flames and smoke.

Aulette and Michalowski's examination of *Fire in Hamlet* suggests a different type of relationship between government agencies and private business corporation. This relationship is where government omissions permit corporations to pursue illegal and potentially harmful courses of action, which *facilitate* the fulfillment of certain state policies. The deaths and injuries were a product of a series of local, state, and federal crimes of omission that facilitated the workers' death at the plant (Aulette and Michalowski; 1993, p. 175).

The critical intersections were between a private business, Imperial Foods Products plant and several government agencies. At the federal level included the U.S. Occupational Safety and Health Administration, U.S. Food and Drug Administration, at the federal level. The state level involved North Carolina-OSHA, the legislature and governor of the state of North Carolina. Finally, the local level was the county building inspectors and the City of Hamlet Fire Department.

Each of these agencies, by omission, for a variety of reasons, failed to perform the control functions assigned to them. They made it possible for the continuation of hazardous conditions at the imperial plant that led to death and injuries of many workers (Aulette and Michalowski; 1993, p.

194). Thus, Aulette and Michalowski revised the definition of state-corporate crime to include harmful actions that are not apparent directly through active state involvement:

> State-corporate crimes are illegal or socially injurious actions that result from a mutually reinforcing interaction between (1) policies and/or practices in pursuit of goals of one or more institutions of political governance; and (2) policies and/or practices in pursuit of the goals of one or more institutions of economic production and distribution (Aulette and Michalowski; 1993, p. 175).

Matthews and Kauzlarich used this revised definition of state-corporate crime to examine *The Crash of ValuJet Flight 592* that killed the passengers and crewmembers (Matthews and Kauzlarich, 2000). On May 11, 1996, ValuJet Flight 592 crashed in the Florida Everglades and killed 105 passengers and 5 crewmembers. The *technical* cause of the crash was a fire that erupted after one or more oxygen generators exploded in a cargo compartment. Governmental investigations indicated that both ValuJet and SabreTech (an airline maintenance company) failed to comply with a host of regulations concerning the presentation, storage, and transportation of hazardous materials by air (Matthews and Kauzlarich; 2000, p. 281).

In addition, the Federal Aviation Administration (FAA) had an instrumental role in the disaster (Matthew and Kauzlarich, 2000). The FAA neglected its oversight of airlines, by not monitoring the general safety of commercial aircrafts as well as its refusal to institute safeguards and guidelines. These safeguards and guidelines would have protected the passengers and crews from crashes on Flight 592 (Matthew and Kauzlarich; 2000, p. 284).

According to Kramer and Michalowski, state-corporate crime is a distinct form of organizational deviance because it involves both vertical and horizontal relationships between business and government, which may have been viewed as separate discrete entities (Kramer and Michalowski, 1991). For instance, the *Fire in Hamlet*, North Carolina, the public might impute the deaths and injured on the Imperial Food Products Company, rather than be concerned about how the state facilitated the crime.

Likewise, in the *Challenger* explosion disaster, the public might view the explosion as an accident, rather than consider how state and corporate goals interacted to produce the death of six astronauts and a schoolteacher (Kramer, 1992). The *Crash of ValuJet Flight 592*, the public would expect ValuJet and SabreTech personnel were responsible for the deaths without recognizing the instrumental role the FAA played in the disaster (Matthew and Kauzlarich; 2000, p. 284). As a result, Kramer and Michalowski have identified two forms of state-corporate crime, *state-initiated corporate crime* and *state-facilitated corporate crime* (Kramer and Michalowski; 1991, p. 6).

State-initiated corporate crime occurs when corporations employed by the government, engage in organizational deviance at the direction of, or with the tacit approval of the government (Kramer and Michalowski, 1991). This includes the space shuttle *Challenger* explosion and the environmental and human injury caused by nuclear weapons production. In both cases, a government agency, NASA in the *Challenger* case and the Department of Energy in the nuclear weapons case, actively pursued a shared goal with a private corporation, Morton Thiokol, Inc. and Rockwell International (Kramer, 1992; Kauzlarich and Kramer, 1998).

The day-to-day manufacture of various parts for the space shuttle and nuclear weapons rests in the hands of private corporations. Both the state and the contracted corporation must produce a commodity into timely and efficient way to achieve mutually held organizational goals. The illegal corporate practices (manufacture of defective products and environmental contamination) resulted from contractual relationships that state agency either strongly encouraged or otherwise explicitly supported (Kramer, 1992; Kauzlarich and Kramer, 1998).

In the *Challenger* case, NASA pressured managers at Morton Thiokol into granting permission to launch the shuttle; even though scientists at Morton Thiokol, Inc. expressed great concern that the O-rings would fail (Kramer, 1992; Vaughan, 1996). NASA, a state agency, *initiated* the socially injurious event. It was through this interaction that a private corporation and a public entity made a decision that ultimately lead to the *Challenger* explosion. Thus, state-corporate crime is a form of organizational misconduct that occurs at the interstices of corporations and government (Kramer; 1992, p. 215). These interstices are what distinguish the crimes committed by corporations acting in the pursuit of organizational goals from those crimes committed by corporations pursuing shared goals with a governmental agency (Kramer; 1992, p. 215).

On the other hand, *state-facilitated corporate crime* occurs when government regulatory institutions fail to restrain deviant business activities, either because of direct collusion between business and "government, or because they adhere to share goals whose attainment would be hampered by aggressive regulation" (Kramer and Michalowski; 1991, p. 6). The state might encourage organizational deviance or in some other way act as a criminogenic force. For example, the examination of *Fire in Hamlet* did not focus on the *technical* cause of injury, or Imperial Food Product's decision to lock fire doors. Instead, it argues that the 25 workers who died were the victims of "a series of social decisions made by a broad array of institutions" (Aulette and Michalowski; 1993, p. 172).

The *Crash of ValuJet Flight 592* and deaths can be linked to the FAA. The FAA ignored two recommendations by the National Transportation Safety Board to (1) place smoke detectors in cargo holds, and (2) reclassify D cargo holds so that they would contain a fire and not allow it to spread to the rest of the plane (Matthews and Kauzlarich; 2000, p. 284). Had the FAA followed these recommendations, flight 592 could have landed safely and more than a hundred lives would have been saved.

Since *state-facilitated corporate crime* involves acts of omission rather than commission, it is one of the least recognizable forms of state involvement in crime (Kramer and Michalowski, 1991). There are varieties of identifiable and specific actions or inactions by governmental agencies that might lead to identifiable social harms. This case study suggests a relationship in which government omissions permit a private business to pursue illegal and potentially injurious courses of action, which facilitate the fulfillment of certain state policies.

This case study will highlight not only the broader structural policies, which contributed to the scandal, but also the very specific items overlooked or ignored by the Bank Board that can be directly linked to the criminal fraud at Lincoln Savings. The Bank Board ignored two recommendations by the Federal Home Loan Bank regulators in San Francisco to (1) place Lincoln Savings in conservatorship in attempt to make Lincoln Savings lucrative, and (2) place Lincoln Savings in receivership. The receivership would had close Lincoln Savings and pay off stockholders (Pepinsky and Jesilow; 1992, p. 73). Furthermore, the Bank Board ignored several condemning reports by federal field regulators and a private accounting firm about Lincoln Savings' fraudulent investments with federally insured funds.

The Development of A Theory of State Corporate Crime

Kramer and Michalowski introduced an integrated theoretical framework to analyze organizational offenses such as state-corporate crimes (Kramer and Michalowski, 1990). They noted there were three major theoretical approaches to the study of corporate crime and each corresponded to a different level of social action. The first theoretical perspective was differential association, which addressed the individual level of action developed by Sutherland (Sutherland 1940, 1949).

The second theoretical perspective was organizational theory, which argued that organizations could be criminogenic either due to the performance emphasis on goals (Finney and Lesieur, 1982; Gross, 1978; Kramer, 1982). Organizational theory focused on specific institutional factors promoting or retarding corporate crime (Kramer, Michalowski, and

Kauzlarich; 2002, p. 272). In addition, organizations could be criminogenic because of defective standard operating procedures (Hopkins, 1978). This organizational approach merged with an anomie perspective on corporate crime (Passas, 1990; Vaughan, 1982, 1983, 1996).

The third theoretical perspective located the criminogenic forces in the wider political economic structure of capitalism (Barnett, 1981; Michalowski, 1985; Quinney, 1977; Young, 1981). The political-economic approach examined the way broad, preexisting societal characteristic interact with the individual and organizational levels of action (Kramer, Michalowski, and Kauzlarich; 2002, p. 272).

Kramer and Michalowski argued that all three approaches could be brought together into an integrated theoretical framework although the differential association, organizational, and political economic perspectives represented divergent approaches to explain corporate and government crime (Kramer and Michalowski, 1990). The structure, dynamics, and cultural meaning associated with the political economic arrangements of any particular society will shape the goals and means of economic and political organizations, as well as the constraints they face (Kramer, Michalowski, and Kauzlarich; 2002, p. 273).

On the one hand, the organizational level of analysis links the internal structure of specific economic or political units with the external political-economic environment. On the other hand, the organizational level of analysis links the way in which the work-related thoughts and actions or the individuals who occupy positions in those units are conditioned by requirements of the positions they hold and the procedures of the organization. In addition, differential association directs us to examine the symbolic reality derived from social interaction within bounded organization niches by focusing on the social relations that give meaning to individual experience (Kramer, Michalowski, and Kauzlarich; 2002, p. 273). This examination of the literature indicates strong parallels in the forces that promote state-corporate crime, on all three approaches, which can serve as an important integrating principle.

CHAPTER 2

POLITICAL ECONOMIC HISTORY OF THE SAVINGS & LOAN INDUSTRY

Historically, a set of political economic arrangements that centered on the American policy to finance homes for American citizens in the 1800s, the Great Depression, post-World War II, economic factors in the 1970s, and bank deregulation in the 1980s, characterize the political economic history context within which the *Lincoln Savings & Loan Scandal* occurred. The overall climate in the S&L industry since the "Bank Holiday" (depositors could not withdraw their funds) had been one in which federal laws and policies toward both the growth and prosperity of the industry had failed. The result has been a history of more government regulations, policies, economic failure, and criminal fraud.

In the nineteenth century, part of the larger American policy effort was to provide a central financing institution to finance homes for American citizens (Pilzer and Deitz; 1989, p. 18). The government policy had allied itself with the "American Dream" for an average citizen to own their homes (Wilmsen; 1991, p. 36). Thus, the origins of the modern Savings & Loan Associations in the United States come from the nation's first American thrift institution called "Oxford Provident Building Association" (Wilmsen, 1991; Rom, 1996).

On January 3, 1831, a growing American middle-class embodied the American Dream in Frankford (Philadelphia), Pennsylvania. Thirty-seven people organized Oxford Provident Building Association (Wilmsen, 1991; Rom, 1996). Oxford Provident did not intend to make a profit. Its purpose was to obtain funds to build residential homes among the proletariats in the textile trade who could not afford to borrow from the aristocratic commercial banks.

Oxford Provident proclaimed that anyone could become a shareholder by contributing an initiation fee (Robinson; 1990, p. 34). Each member paid five-dollars a share and three-dollars each month (Brumbaugh Jr.; 1988, p. 145). Whenever the association had $500 for a loan, shareholders auctioned the funds to the highest bidder to build or buy a home (Rom; 1996, p. 24). The association liquidated after the last shareholder built a home. Because of Oxford Provident Building Association, building societies gradually spread from Philadelphia throughout the United States over the next few decades (Brumbaugh Jr.; 1988, p. 4).

In 1850, building societies incorporated and began to take on the idea of savings banks. Shareholders no longer felt a personal interest to take an active role in the association's affairs, and professional managers took over the day-to-day operations. These institutions began making loans to people who planned to build houses on their land as well as financing the acquisition of existing homes. Therefore, the two ideas began the genesis of the Building & Loan Societies.

As the United States entered the twentieth century, the Building & Loan Societies became the Savings & Loan Associations (S&Ls). There were 5,356 S&Ls with $571 million in assets (Brumbaugh Jr., 1988; Robinson, 1990). In the 1920s, as income and wealth grew, there were

8,633 S&Ls with $2.5 billion in assets (Brumbaugh Jr.; Day, 1993). By 1925, the S&L industry reached its peak at 12,403 S&Ls with $5.5 billion in assets (Robinson; 1990, p. 36).

In 1927, a movement began to initiate federal regulations for S&Ls. Politicians attempted to pass legislation before Congress to create a central reserve system to protect and stabilize the S&L industry (Marvell; 1969, p. 18). However, on October 29, 1929, the stock market crashed before Congress could take any action to assist the 11,777 S&Ls with $8.8 billion in assets (Eichler; 1989, p. 7). As a result, the Great Depression occurred, and the industry suffered large losses. In 1930, 190 S&Ls failed, and depositors lost $24.5 million (Pilzer and Deitz; 1989, p. 33). In 1931, 126 S&Ls failed, and depositors lost $22.3 million (Robinson; 1990, p. 36).

In December 1931, Republican President Herbert Hoover came under pressure to relieve the banking industry's crisis. In his State of the Union address, he recommended that Congress create a Federal Home Loan Bank System to promote home ownership. President Hoover's recommendation had two main goals for federal legislation:

> (1) For the present emergency purpose of relieving the financial strains upon sound savings and loan institutions, savings banks, deposit banks, and farm loan banks that have been giving credit through the medium of small mortgage loans upon urban and farm properties used for homes, thereby, relieving pressure upon home and farm owners.
>
> (2) For Congress to provide safeguards against the repetition of such experiences in the future (Marvell; 1969, p. 21).

On July 22, 1932, Congress passed and President Hoover signed the Federal Home Loan Bank Act of 1932, which established the Federal Home

Loan Bank System (Calavita and Pontell; 1990, p. 311). The core elements of the Federal Home Loan Bank System were the Federal Home Loan Bank Board and the Federal Home Loan Banks. The Federal Home Loan Bank Board was an independent agency of the executive branch of the federal government located in Washington, D.C. Its governing body was the Bank Board, composed of a five-member commission (later reduced to 3 members) appointed by the President of the United States (Rom; 1996, p. 30). Thus, the system was an imitation of the Federal Reserve System for commercial banks.

Later that year, the Federal Home Bank System created twelve districts of Federal Home Loan Banks throughout the country (Day; 1993, p. 42). The Federal Home Loan Banks had two major responsibilities (1) to lend money to member S&Ls within their geographical area, and (2) to regulate S&Ls in accordance with the Bank Board regulations and laws. In addition, the district banks sold stock to their member S&Ls. They used the proceeds to issue bonds and used the receipts of these sales for short- or long-term loans to member S&Ls (Rom; 1996, p. 71).

In 1932, the grim statistics continued for S&Ls failures. One hundred and twenty-two S&Ls failed, and depositors lost $52.8 million (Pilzer and Deitz; 1989, p. 33). Therefore, the United States League of Local Building and Loan Associations (later named The United States League of Savings Associations) [U.S. League], the nation's largest and most powerful thrift trade association, lobbied for expanded federal regulation and federal deposit insurance (Day; 1993, p. 42). Thus, an idea of government insurance began to gain support from Congress to protect shareholders' funds and maintain the flow of funds for housing.

On April 14, 1932, Representative Henry Steagall of Alabama, a Democrat who chaired the House Banking and Currency Committee, sponsored a deposit insurance bill guaranteeing bank deposits up to $2,500 (Pilzer and Deitz; 1989, p. 38). He feared that President Hoover would make an issue of insuring bank deposits, and voters would reelect him if Democrats did not act upon federal insurance deposits. Five days later, the House Banking and Currency Committee recommended passage of the bill (Pilzer and Deitz; 1989, p. 39). The House's Democratic leadership approved it, but Senate Banking Chairperson Senator Carter Glass killed the bill in the Senate (Pilzer and Deitz, 1989; Rom, 1996).

Senator Glass, former Secretary of the Treasury under President Woodrow Wilson, was an important enemy of regulation legislation in the Senate. Senator Glass's conservative background and political sentiments were with the American Bankers Association (ABA). The ABA controlled the big East Coast banks opposed to guaranteeing savings deposits. They feared that deposit insurance would require big East Coast banks to pay the bill for supporting weaker financial institutions in the South and Midwest, where imprudent management practices were more common.

On March 4, 1933, President Franklin Delano Roosevelt took the oath of office as the nation's thirty-second president. President Roosevelt's greatest crisis was the collapse of the U.S. Banking system and the S&L industry. From 1929 through 1932, 597 S&Ls failed with $411 million in assets (Eichler; 1989, p. 9). Therefore, President Roosevelt declared a "Bank Holiday" from March 5 through March 9 to buy time for a solution (Robinson; 1990, p. 36). However, many Americans believed that federal deposit insurance was essential to reform the banking system, and they wanted protection. Over one hundred thousands Americans had at risk approximately $4 billion during the "Bank Holiday" (Pilzer and Deitz; 1989, p. 36).

On May 10, 1933, Senator Glass and Representative Steagall introduced the Glass-Steagall's deposit insurance bill in the Senate and House chambers. The difference between the two bills was the way each treated deposit guarantees. On the one hand, Representative Steagall guaranteed the first $2,500 deposits by a fund financed by insurance premiums paid by participating banks (Pilzer and Deitz; 1989, p. 48). On the other hand, Senator Glass's proposal (more acceptable to big banking interests) offered to continue government-financed funds restricted to banks that were members of the Federal Reserve System. This restriction effectively prohibited deposit insurance for members of state-chartered banks and S&Ls. Furthermore, Senator Glass wanted to create a "liquidating corporation," which would advance to depositors the estimated funds they would receive when the firm liquidated (Rom; 1996, p. 272).

On June 12, 1933, President Roosevelt accepted the inevitable. He acknowledged the strength of popular support behind the federal deposit insurance. What emerged was a less than full-fledged insurance system:

> (1) The Federal Reserve System would guarantee deposits of up to $2,500 per member immediately in all banks that were members of the Federal Reserve System, and to any non-member certified state bank that federal banking authorities as solvent.
>
> (2) Participating banks would finance the insurance fund by

assessing a premium of 0.5 percent of their insured deposits.

(3) Effective July 1, 1934, create a Federal Deposit Insurance Corporation to administer funds to guaranteed deposits (Pilzer and Deitz; 1989, p. 52).

Furthermore, President Roosevelt asked Congress for more legislation to help the S&L industry. Foreclosures increased by an average of 25 percent each year between 1926 and 1932 from fewer than 70,000 to almost 250,000 annually (Eichler, 1989; Rom, 1996). The industry's analyst estimated that 40 percent of home mortgage loans were in default that caused a 15 percent reduction in the size of the S&L industry (Robinson, 1990; Rom, 1996). Therefore, Congress enacted the Home Owner's Loan Act of 1933 to relieve homeowners from foreclosure and bring new finance to the housing market.

The Home Owner's Loan Act established the Home Owner's Loan Corporation (HOLC). HOLC's major purpose was to buy delinquent home mortgages from banks, S&Ls, and other mortgage lenders with the intent to refinance those mortgages for fifteen-years at interest rates and required monthly payments to pay off the loan (Rom; 1996, p. 31).

In addition, the Home Owner's Loan Act authorized the Bank Board to grant federal charters to S&Ls, to regulate assets, liability holdings, and to promote growth in the industry. The language appears in a paragraph of the Home Owner's Loan Act:

> The Act is to provide local mutual thrift institutions in which people may invest their funds and provide for the financing of homes. The Bank Board is authorized under such rules to provide for the organization, incorporation, examination, operation, and regulation of associations known as Federal

> Savings and Loan Associations, considered the best practices of local mutual thrift and home-financing institutions in the United States (Marvell; 1969, p. 112).

Federally chartered S&Ls had to have at least 400 members. Members could not own more than 10 percent of the stock, and control groups could not hold more than 25 percent in stock (Rom; 1996, p. 129). The chartering structure for S&Ls was, thereby, made parallel to the dual structure that applied to banks. S&Ls could choose to have either a state charter or a federal charter. By the end of 1934, over 2,000 S&Ls became federally chartered members of the Federal Home Loan Banks (White; 1991, p. 54).

In addition, the Bank Board issued three major regulations and the methods of "borrowing short and lending long" that the Bank Board considered the "best practices" for the S&L industry (White; 1991, p. 32). The first major regulation was economic regulation that attempted to control the economic power or market power of regulated entities. It had four forms of federal regulations: (1) usury ceilings that limited the interest rates charged on long-term, fixed interest rate, home mortgages (long-term mortgages), (2) ceiling on the interest rates paid on short-term saving's deposits (short-term deposits), (3) limitations on branch locations within states and across states where new branches would encroach on another incumbent's territory, and (4) limitations on who could enter the depository business, etc.

The second regulation was that federally chartered S&Ls had to meet minimum net-worth (capital) levels, and it had to maintain internal practices and procedures that geared toward safe practices. It involved procedures for prudent underwriting loans through background checks on borrowers' ability to repay their mortgage loans. Finally, the third regulation involved consumer information and protection regulation. It involved specified information disclosures on mortgage terms and deposit terms. In addition, it focused on S&Ls lending practices of borrowing short and lending long to local communities (White, 1991; Ermann and Lundman, 1992).

Despite the new law, most Americans who lived through the Great Depression were not enthusiastic about putting their money into any financial institutions. In the darkest year of 1933, eighty-eight S&Ls failed, and depositors lost almost $44 million (Pizzo, Fricker and Muolo; 1989, p. 11). During the 1930s, 1,706 S&Ls failed, and depositors lost $200 million (Pizzo, Fricker, and Muolo; 1989, p. 11). The public remained circumspect of the financial system. Therefore, the federal government had to restore the public confidence in order for the financial system to recover its strength.

On July 1, 1934, Congress enacted the Federal Deposit Insurance Corporation (FDIC) for the commercial-banking industry. The FDIC permitted mutual savings banks to join the Federal Reserve System. However, they would not allow federally chartered S&Ls to become members. The S&L industry perceived that the FDIC gave banks a competitive advantage. Thus, the U. S. League sought to obtain federal deposit insurance for the industry. As a result, the second principal building block of the S&L industry was the National Housing Act of 1934 (Calavita and Pontell; 1990, p. 235)

The National Housing Act of 1934 had two main components. First, the Act created federally guaranteed home mortgage insurance administered by the new Federal Housing Administration (FHA). The FHA provided federal insurance against default by low-income home loan borrowers and in the process distributes the availability of home loans throughout the country (Day; 1993, p. 43). Second, the FHA guaranteed long-term mortgages, twenty-year maturities, limited to 5 percent and 20 percent down payment of the home price (Rom; 1996, p. 31). President Roosevelt expected that during the Great Depression, citizens would be able to afford home mortgage loans under these terms. Therefore, by providing federal insurance for home mortgages, Congress believed it would lead more lenders to make such loans (Rom; 1996, p. 31).

In addition, the National Housing Act established the Federal Savings and Loan Insurance Corporation (FSLIC) to insure federally chartered S&L shareholder's short-term deposits up to $5,000 (Day; 1993, p. 43). The FSLIC was to protect the system against massive withdrawal, not to save federally chartered S&Ls from failure. The federal government did not back the FSLIC by Full Faith and Credit. Therefore, the federal government was not legally obligated to assume responsibility for insuring short-term deposits if the S&L industry collapsed.

Congress hoped that the establishment of the Federal Home Loan Bank Act of 1932, Home Owner's Loan Act of 1933, and the National Housing Act of 1934 would promote the construction of new homes and protect the S&L industry. President Roosevelt's New Deal Reform worked. Shareholders with FSLIC-insured accounts no longer lost money, and they no longer feared losing money. In addition, homeowners did not default on their mortgage loans. Home foreclosures declined in number every year after 1933 to pre-depression levels by 1940 (Rom; 1996, p. 37). Thus, the S&L industry entered a lengthy period of postwar growth and prosperity for more than forty years (Brumbaugh, Jr.; 1988; Greider, 1990; Rom, 1996).

Postwar Growth and Prosperity

In 1940, the S&L industry was prosperous. There were 7,521 federally chartered S&Ls with $5.7 billion in assets (Eichler; 1989, p. 7). S&Ls obtained most of their funds through short-term deposit accounts, which were stable and low cost source of funds. Unlike banks, S&Ls were exempt from interest rate ceilings, so they could obtain sufficient short-term deposit by paying slightly higher rates than banks.

S&Ls used most of their short-term deposits to make long-term mortgages (Rom; 1996, p. 37). These deposits were the major source of funds for investments in home mortgages. However, the United States Government curtailed production of civilian goods when the government got involved in World War II. The government placed emphasis on the United States Military. As a result, construction mortgage lending became dormant (Strunk and Case; 1988, p. 20).

After World War II, the savings and loan industry was part of the United States Economic Recovery efforts (Glasberg and Skidmore; 1991, p. 27). In 1944, Congress passed the Servicemen's Readjustment Act known as the "GI Bill of Rights" (White; 1991, p. 57). Under the GI Bill, the federal government guaranteed it would repay part of the GI loan under certain conditions that reduced the risk to lenders. In turn, the lender granted long-term mortgages with smaller down payments and charged veterans half a percentage point less than the going rate of 4.5 percent (Robinson; 1990, p. 14). As a result, GI loans were a major role in the housing industry. Forty-four percent of S&L's long-term mortgages were GI loans with $37.7 billion in assets (Brumbaugh Jr., 1988; Eichler, 1989). Thus, the regulatory framework established under the New Deal Reform contributed to the economic growth and prosperity of the S&L industry.

Throughout the post-Depression years, the S&L industry enjoyed an extremely favorable economic and competitive climate. S&Ls loans grew along with the population, the economy, and especially, the housing market. Between 1945 and 1965, the industry built over 30 million new homes, and long-term mortgages financed the vast majority of home sales (Rom; 1996, p. 37). As a result, the industry became the world known as "3-6-3" (White; 1991, p. 59). S&L executives borrowed 3 percent interest from shareholder's short-term deposits. They loaned it to homebuyers at 6 percent interest on long-term mortgages; and S&L executives were on the golf course by 3:00 P.M. This method was borrowing short and lending long (White; 1991, p. 59).

The Potential Flaw of Borrowing Short and Lending Long

There was one potential flaw with the method of borrowing short and lending long. Throughout this period, the industry became vulnerable to economic fluctuations. This weakness came about because S&Ls financed long-term mortgages with short-term deposits. If a volatile market interest rates increased it would expose the "maturity mismatch" or "interest rate risk". For example, S&Ls would be in a dilemma, if S&Ls attempted to retain short-term deposits by raising the interest rates paid, their profits would shrink. At some point, the profits would disappear. If S&Ls did not raise the interest rates, they risked shareholders withdrawing their short-term deposits and deposit them where they could earn more interest. If this happened, S&Ls could either attempt to maintain their size by borrowing funds elsewhere, which would raise costs, or they could shrink, which would lower profits (Rom; 1996, p. 38).

In 1966, the potential flaw of borrowing short and lending long became a reality for the S&L industry. The industry began to experience external pressures. As the United States stepped-up its involvement in the Vietnam War, the federal government borrowed money to finance the Vietnam conflict and President Lyndon B. Johnson's Great Society Program. Likewise, industries wanted to borrow money to increase their plants and equipment, and consumers wanted to buy more goods on the installment plan. At the same time, the Federal Reserve Board sought to prevent inflation by limiting the supply of funds available for lending.

Under the United States Economic System, the price of an object increases when the supply is unable to meet the demand. Money is no exception to this rule. The cost of money is the interest a borrower must pay. If money is scarce, the interest rate rises. As inflation increased, it created higher interest rates exceeding the 3 percent interest that S&Ls paid on short-term deposits. For example, in January 1964, short-term interest rates increased from 3.53 percent to 3.86 percent by December 1964. In January 1965, it increased again from 3.83 percent to 4.36 percent by December 1965 (White; 1991, p. 62). In January 1966, the interest rate continued to increase from 4.60 percent to 5.39 percent by October 1966 (Rom; 1996, p. 40).

These interest rate increases had two important consequences for the S&L industry. First, shareholders began looking for financial instruments that paid higher market interest rates. Commercial banks benefited by offering higher interest rates on short-term deposits and attracted funds that S&Ls would have otherwise received (Rom; 1996, p. 40). Second, home lending and home building suffered. Production of single-family homes decreased to a decade low of 1.15 million (Eichler; 1989, p. 37). Because of the interest rate increase, the S&L industry lost approximately $7 billion in home-construction expenditures and an estimated loss of 800,000 construction jobs (Marvell, 1969; Eichler, 1989).

The interest rates increase scared lawmakers into thinking that the affordable home mortgages would perish if they did not act (Wilmsen; 1991, p. 38). Congress' initial response to the industry's external pressure was to seek governmental control over the interest rates paid on short-term deposits. Congress' reasoning was that if S&Ls did not have to pay too much for short-term deposits, S&Ls would not have to charge too much for long-term mortgages (Pizzo, Fricker, and Muolo; 1989, p. 10). Therefore, Congress decided to take control of interest rate ceilings.

The Creation of Interest Rate Ceilings

In September 1966, Congress passed the Interest Rate Control Act known as "Regulation Q" (White; 1991, p. 62). Regulation Q guaranteed federally chartered S&Ls slightly higher interest rates on short-term deposits than banks. The Bank Board set an interest rate ceiling at 3/4 percent of 1 percent more than commercial banks on short-term deposits (Eichler; 1989, p. 23). From September-December 1966, interest rate ceiling on short-term deposits for commercial banks was 4 percent compared to S&L's 4.75 percent. This was called "thrift differential" (White; 1991, p. 62).

By January 1967, S&Ls began to attract new short-term deposits that increased the industry's growth to $10.7 billion in assets (Lowy; 1991, p. 15). Short-term accounts supplied three-fourths of all deposits in S&Ls (Brumbaugh Jr.; 1988, p. 14). Regulation Q was a powerful marketing tool for the industry. "We pay more than any bank" was a common advertising theme (Strunk and Case; 1988, p. 39). Thus, for the remainder of the 1960s, the Interest Rate Control Act permitted S&Ls to flourish without depriving homeowners of long-term mortgages.

The S&L industry entered the 1970s with 5,699 federally chartered S&Ls with $17.6 billion in assets that continued to borrowed short and lending long (Brumbaugh Jr.; 1988, p. 7). S&Ls used those funds to underwrite long-term mortgages for younger homebuyers. These buyers reaped the benefits of borrowing at 8 percent or less a year to acquire property that appreciated at 10 percent or more a year (Pilzer; 1989, p. 59). Meanwhile, Regulation Q had narrowed to 1/2 percent (Eichler; 1989,

p. 23). From September 1970 to December 1970, the ceiling interest rate on short-term deposits for commercial banks was 4.5 percent compared to S&Ls 5.0 percent (White; 1991, p. 63). Again, this thrift differential allowed S&Ls to continue to attract short-term deposits. However, several economic factors changed both the fortunes of the S&Ls and the parameters within they operated.

The Consequences of Interest Rate Ceilings

A combination of events produced double-digit inflation and rising interest rates that re-created the flaw of borrowing short and lending long. Moreover, high interest rates and slow growth affected the S&L industry. S&Ls were locked into long-term mortgages from previous era that were limited by regulation to pay no more than 5.5 percent interest on new short-term deposits (Ermann and Lundman; 1992, p. 236). As a result, the industry found it difficult to attract new money when inflation outpaced the 5.5 percent return on short-term deposits.

Meanwhile, President Richard M. Nixon was aware of the political fallout from economic fluctuations. He attributed his 1960 defeat to the mild recession of 1960-1961, caused by, or at least worsened by a stringent money policy (Eichler; 1989, p. 34). President Nixon wanted rapid growth and price stability. He expected Federal Reserve Chairperson Arthur Burns to help accomplish his goal by imposing wage and price controls. President Nixon allowed the Federal Reserve to increase the money supply by letting the currency's value tumble around at the whim of investors (Wilmsen; 1991, p. 38). Therefore, President Nixon obtained the economic environment of high growth and low inflation at 3.4 percent that he wanted to win reelection (Pizzo, Fricker, and Muolo; 1989, p. 333).

In 1972, President Nixon lifted the wage and price controls after winning reelection. Chairperson Burns invoked a monetary restraint on an economy that had a built-in bias toward price inflation at the slightest opportunity. Oil producers in the Middle East decided they were not getting enough money for their crude oil, and oil prices skyrocketed. As a result, it exacerbated the Organization of Petroleum Exporting Countries (OPEC) embargo that resulted in inflationary oil prices.

In October 1973, during the Arab-Israeli War, the Arab-dominated OPEC announced an embargo on oil exports to the West, which caused a dramatic increase in the price of crude oil from \$2.50 to about \$11 per barrel (Simon and Eitzen; 1993, p. 68). The oil companies then announced a dramatic storage of imported oil. They stated, "The demand for domestic oil could do nothing but increase" (Seidman; 1993, p. 22). Thereupon, the oil companies announced increased prices for domestic crude oil equal to the increase of OPEC oil. By 1974, the oil embargo increased the consumer price index to 12.2 percent (Eichler, 1989; Robinson, 1990; Seidman, 1993). Consequently, this affected other economic forces, and a new word entered the economic jargon, "Stagflation" (Eichler; 1989, p. 34).

In April 1975, the nation experienced the first serious postwar recession (Seidman; 1993, p. 22). President Nixon's successor, Gerald Ford and his administration inherited the high inflation that was a result of the oil-embargo by the Arab states. President Ford's Administration attempted to solve the inflation problem by cutting government expenditures, veto numerous spending bills that lowered the inflation rate to about 6 percent, and interest rates decreased (Seidman; 1993, p. 22). By January 1976, the economy had recovered and home sales began to surge. The inflation rate remained at 6 percent, and S&Ls charged 8.5 to 9 percent interest on long-term mortgages (Eichler; 1989, p. 43).

During the 1976 Presidential Campaign, the nation got its first warning of what to expect from Jimmy Carter. Bert Lance, whose Georgia bank was a crucial financial backer of Carter, told the press that his friend had proved in Georgia politics that "he campaigns liberal, but he governs conservative" (Sherrill; 1990, p. 592). As a candidate, Carter promised that unemployment would be his top priority. As soon as he became the 39th President of the United States, he switched and said, "Winning business confidence was more important" (Sherrill; 1990, p. 592). He vowed that he would immediately push for bank deregulation.

In 1978, President Carter replaced Federal Reserve Chairperson Burns with William Miller. The President opted for unrestrained money to preclude a recession. He and Miller kept the GNP rising and held unemployment in check at 6 percent with inflation at 6 percent (Eichler; 1989, p. 36). Meanwhile, short-term interest rates on three-month Treasury-bills paid 6.43 percent compared to Regulation Q's ceiling at 5.25 percent for short-term deposits at S&Ls (White; 1991, p. 68). S&Ls shareholders realized that Regulation Q's interest rate was far below the market rates for short-term investments. As a result, shareholders shopped for new investments with higher interest rates for their money.

This competition came from mutual money market funds (MMMFs). Reserve Fund of New York City, an innovative investment company, introduced the first MMMFs that attracted S&L's shareholders with at least $10,000 (White; 1991, p. 68). Reserve Fund offered between 10 and 12 percent interest rates on short-term deposits (Calavita and Pontell; 1990, p. 236). As a result, the higher market interest rates threatened the possibility for massive withdrawals of short-term deposits from S&Ls (Pontell and Calavita; 1993, p. 33).

In response to the threat of S&L's short-term deposits, President Carter's Administration and Congress developed a new view of the industry's problems. The major cause of the industry's difficulties was restrictions on long-term mortgages. As Congress saw it, "If the problem was that shareholders were taking their money out of S&Ls in order to get better returns available elsewhere, then why not simply let S&Ls pay shareholders higher rates" (Pilzer and Deitz; 1989, p 69). Therefore, the Bank Board authorized a temporary savings certificate to be more competitive in the higher interest rate environment.

On June 1, 1978, the Bank Board authorized S&Ls to offer a six-month "money-market certificate" (MMC) with a $10,000 minimum deposit priced 1/2 percent above the six-month Treasury-bill rates that fluctuated between 10 and 12 percent (Pilzer and Deitz, 1989; Lowy, 1991; White, 1991; Foust, 1993). For the first time since 1966, S&Ls could pay market interest rates on at least one form of deposits. These MMCs had an immediate and massive effect on the industry. By November 1978, S&Ls issued $34 billion in MMCs (Rom; 1996, p. 140).

By January 1979, the elements of tragedy were in place. The industry relied on short-term deposits to finance long-term mortgages that had a dangerous maturity mismatch. By June 1979, 20 percent of all S&L's short-term deposits were in six-month MMCs at 12 percent interest rates (Brumbaugh Jr., 1988; Lowy, 1991). However, the law required S&Ls to invest those high-cost funds in long-term mortgages that earned a lower interest rates than the 12 percent on MMCs (Pilzer and Deitz; 1989, p. 66). As a result, six-month MMCs cost the industry $5 billion a year; exactly the amount the industry made in its best year (Lowy; 1991, p. 16).

Meanwhile, President Carter appointed Paul Volcker to chair the Federal Reserve Board to combat inflation (Long; 1993, p. 9). Chairperson Volcker was a notoriously well-trained guard dog for the Eastern money establishment. He had been a Chase Manhattan banker, a Treasury official in President Johnson and Nixon Administrations, and head of the Federal Reserve Bank of New York. The bankers knew that Volcker was mean enough to destroy the economy to preserve the hardness of their dollars (Lowy; 1991, p. 16). Volcker made a decision with pernicious results for the S&L industry.

On October 6, 1979, Volcker announced that the federal government would no longer try to restrain rampant inflation by holding down interest rates. Instead, the new policy abandoned interest rate stability and focused on restricting the growth of the nation's money supply to combat inflation (Ermann and Lundman; 1992, p. 236). Volcker stated, "The standard of living of the average American [not the upper-class] has to decline" (Sherrill; 1990, p. 592). Colleague R. Dan Brumbaugh Jr., former deputy chief economist at the Federal Home Loan Bank Board, repeatedly warned Volcker that "his goals for the general economy would have expensive consequences if he did not moderate and allow interest rates to fall" (Day; 1993, p. 60). Volcker ignored his warnings. His strict control over the money supply sent interest rates to 13.3 percent and contributed to a serious recession (Ermann and Lundman; 1993, p. 236). From October-December 1979, inflation reached almost 16 percent (Lowy; 1991, p. 17). As a result, the average American could not afford to buy a home, a car, and unemployment was 5.7 percent (Sherrill; 1990, p. 592).

Many S&L executives understood the devastating effect Volcker's policy would have on their business. The effect was the cost of borrowing money. Before S&Ls could lend money for long-term mortgages, they had to have it. Shareholders withdrew their money from their short-term accounts that paid 5.5 percent, and they invested it in money market funds that paid double-digit returns. As a result, S&Ls faced defaults and foreclosures from the recession, combined with competition from high-yield investments given the new hikes in the interest rate (Ermann and Lundman; 1992, p. 236).

However, the Bank Board recognized that Regulation Q, the most consistent regulation, undercut the S&Ls. Regulation Q hindered the ability for S&Ls to complete for short-term deposits. Therefore, the new Bank Board Chairperson Preston Martin suggested two proposals that would reduce S&Ls' interest rate risk. First, Martin's proposals would have allowed S&Ls to offer Adjustable Rate Mortgage loans (ARMs). ARMs would have improve S&L's earnings during times of rising interest rates by increasing the rate paid on long-term mortgages (Rom; 1996, p. 43). Second, if S&Ls could have made more investments other than home mortgages, it would have reduced the interest rate risk. Martin argued that other investments would have shorter maturities allowing S&Ls to diversify into other business sectors (Rom; 1996, p. 44).

However, the political-economic decision of the House and Senate Banking Committee blocked both proposals for improving the growth and prosperity of the S&L industry. Chairperson Senator Henry Proxmire and Representative Fernard St. Germain indicated that they opposed ARMs on the consumer's protection grounds. They feared that S&Ls would arbitrarily raise the interest rates on long-term mortgages (Pilzer and Deitz; 1989, p. 68). Therefore, the Banking Committees believed that Regulation Q was the solution to the industry's problems (Strunk and Case; 1998, p. 46).

Because of this political-economic history, the government failed to provide significant regulation for the S&L industry, which had been the central backbone of financing homes for American citizens. The industry operated in a volatile environment to the industry's home financing, an environment created by the government that had actively blocked the ability for S&Ls to compete for short-term deposits in order to provide long-term mortgages, which caused many of S&Ls into insolvency.

CHAPTER 3

WHERE DEREGULATION WENT WRONG: SETTING THE STAGE FOR FAILURE

The history of the S&L's industry political economy revealed a state in which it blocked the industry's effort to control its home financing environment by a government favoring an anomalous industrial policy. However, this political-economic climate alone does not explain the complete dynamics that led to the *Lincoln Savings & Loan Scandal*. The Bank Board could have closed Lincoln Savings when board members were aware of Lincoln's risky investments and criminal activities. In addition, regulators had the legal authority to seize Lincoln Savings from American Continental.

What kept these federal agencies from closing or seizing Lincoln Savings? What led Congress to deregulate the S&L industry? This chapter answers the question in which the scandal occurred. It outlines the specific pattern of the industrial relations among the S&L industry, the Federal Home Loan Bank Board, Lincoln Savings, and American Continental Corporation.

In January 1980, the S&L industry's 4,613 S&Ls, with $630 billion in assets, entered into a new economic environment that affected the market value of long-term mortgages (Eichler; 1989. p. 40). The consumer price index stood almost 45 percent above where it had been when President Gerald Ford left the White House (Pilzer and Deitz; 1989, p. 67). The prime rate that commercial banks charged most corporate customers approached 20 percent (Pilzer and Deitz; 1989, p. 67). Both inflation and interest rates were more than 12 percent (Eichler; 1989, p. 40). Because of the new economic environment, one-third of the industry's S&Ls with 3 percent long-term mortgages lost $4.6 billion (Foust, 1993; Rom, 1996).

Furthermore, the market value of home loans was far less than the interest rate on S&L's six-month MMCs. The average yield on S&L's long-term mortgage portfolios was 8.8 percent. The interest rate on six-month MMCs was 14 percent (Eichler, 1989; Pilzer and Deitz, 1989). As a result, eighty-five percent of the industry's S&Ls lost money (Sherrill; 1990, p. 594). Industry analysts estimated that the liabilities would exceed the market value of S&L's assets by almost $200 billion (Murry; 1992, p. 2).

The Solution for the S&L Industry's Difficulties

In an effort to reduce the adverse effects of the unexpected economic forces, a new ideological movement gathered momentum. The U.S. League argued that the policies constituting the congressional mandate of the 1930s were an anachronism, given the economic troubles of the 1970s (Glasberg and Skidmore; 1997, p. 29). In the mid-seventies, congressional actions began to turn against the savings and loan industry. Lincoln Savings and other S&Ls was not the best route through which to promote the housing industry. Instead, Congress saw S&Ls as an inhibitor to congressional socioeconomic goals and found them imposed with additional operation expenses. Policy makers discussed lifting restrictions on S&Ls to allow them to compete equitably for new money and invest those funds in lucrative ventures (Calavita, Pontell, and Tillman; 1997, p. 11). Therefore, Congress and the Bank Board both agreed that bank deregulation was the solution for the industry's difficulties.

Bank deregulation would require a shift in the industry's structure. This deregulatory shift would relax interest rate limits on S&Ls; it removed restrictions on banking, real estate, and securities investments (Glasberg and Skidmore; 1997, p. 29). Congress' supported deregulation legislation for airlines, natural gas, communication, trucking and railroad industries (White; 1991, p. 72). Therefore, the majority of legislators concurred to turn the S&L industry over to an autonomous industry of the free market system.

Representative Fernando St. Germain, Chairperson of the House Banking Committee, had been at the vanguard for deregulation of the S&L industry. His promotion of deregulation coincided with his cozy relationship with lobbyists for the U.S. League (Calavita, and Pontell and Tillman; 1997, p. 90). The U.S. League was the most powerful lobbying group in Washington, D.C. When it came to thrift matters in the U.S. Congress, the U.S. League and many of its affiliates were the *de facto* government. "What the League wanted, it got. What it did not want from Congress, it had killed" (Jackson and Thomas; 1989, p. A1).

U.S. League Chairperson William O'Connell bragged about the influence enjoyed by his association. "Everything we tried to do we were successful" (Calavita, Pontell and Tillman; 1997, p. 90). The League wanted deregulation. Therefore, Representative St. Germain sponsored the Depository Institutions Deregulation and Monetary Control Act

(DIDMCA) that would increase the flow of S&L's short-term deposits by relaxing the restrictions on Regulation Q interest rates.

Setting the Stage for Failure

On March 31, 1980, Congress passed and President Carter signed the Depository Institutions Deregulation and Monetary Control Act designed to phase out Regulation Q over the next six years (Simon and Eitzen, 1993; Glasberg and Skidmore, 1997). In addition, the DIDMCA included significant regulatory changes to extend the range of S&Ls' investments:

> (1) Federally chartered S&Ls could establish branch offices and mobile facilities state wide within the home state and 100 miles from the home office.
>
> (2) FSLIC members could borrow up to 50 percent of assets, although they may pledge only 25 percent of assets to secure outside borrowings.
>
> (3) FSLIC members could make real estate loans with out regard to the geographic location of the secured property.
>
> (4) Federally chartered S&Ls could make loans in excess of 90 percent of value on one to four family properties.
>
> (5) Statutory net-worth requirement reduced from 5 percent of insured accounts to 3 percent, the amount by which assets exceed liabilities (Brumbaugh Jr.; 1988, p. 42).

The lower net-worth requirement meant that S&Ls needed a smaller capital base to comply with federal regulations. S&Ls could increase the total amount of loans they made with a smaller buffer against losses, the higher the level of capital the more solid the S&L (Robinson; 1990, p. 38).

At the same time the law unleashed S&Ls to compete for new money, Congress bolstered the federal protection accorded to these "private enterprise" institutions by increasing the FSLIC insurance from a maximum of $40,000 to $100,000 per deposit (Ermann and Lundman; 1992, p. 237). In a conference room in the United States Capitol, members of the House and Senate held an esoteric meeting to produce a bill that would compromise limits on increasing FSLIC insurance. The Senate bill called for an increase to $50,000 (Calavita, Pontell, and Tillman; 1997, p 92). The House bill included no increase (Lowy; 1991, p. 19). However, Representative St. Germain proposed a "compromise" limit of $100,000 (Adams; 1990, p. 17).

Representative St. Germain and Senator Cranston persuaded Representatives in the House and Senators in the Senate to increase the FSLIC insurance protection to $100,000 without any congressional debate (Lowy; 1991, p. 19). Thus, the combination of net-worth requirement of 3 percent and increased FSLIC protection from $40,000 to $100,000, allowed S&Ls access to unprecedented amounts of federally insured funds to invest in the free markets. Since the maximum insured deposit was $100,000, S&Ls packaged brokered deposits as $100,000 certificates of deposit (Calavita, Pontell, and Tillman; 1997, p. 12). S&Ls could raise millions of dollars from the certificates of deposit if they paid the higher interest rates (Pilzer and Deitz; 1989, p. 73). However, a new problem arose.

The DIDMCA triggered an even more pronounced "negative rate spread." S&Ls received new money at the higher interest rates to attract short-term deposits, but they had to invest those funds at a lower rate in long-term mortgages. As a result, insolvent S&Ls' losses measured in billions of dollars (Edward J. Kane; 1987, p. 77). Yet, insolvent S&Ls continued to exist because the FSLIC did not have enough funds to pay off losses of that magnitude. By the end of December 1980, rising interest rates took their toll on the economic health of the S&L industry. Industry analysts estimated that almost half of the industry's 4,613 S&Ls would lose $4 billion a year if insolvent S&Ls continue to operate in the red (Pontell and Calavita; 1993, p. 34).

A New Administration Failed to Close Insolvent S&Ls

On January 20, 1981, President Ronald Reagan's Administration prepared to take office. An anonymous memo on the S&L industry's crisis circulated among members of the Reagan transition team. "The new administration may well face a financial crisis not of its own making. Confidence in the entire financial system could evaporate" (Pilzer and Deitz; 1989, p. 67). Therefore, The U.S. Treasury Department formulated a set of policies to deal with the wave of S&L's failures:

> (1) The current problem is interest rates. High interest rates are due to inflation, which the administration is going to cure. Therefore, the problem is temporary.
>
> (2) The problem is a liquidity problem caused by interest rate regulation. If Congress deregulates interest rates, S&Ls will be able to attract funds. Therefore, Congress should deregulate rates.
>
> (3) There is no money in the budget for bailouts (Reagan had been against the bailouts of New York City and Chrysler). Therefore, if S&Ls need assistance that has no budgetary cost to the government.
>
> (4) The important thing is to get real deregulatory legislation

to give S&Ls the same powers as commercial banks.

The administration did not believe that the negative net-worth was significant. Therefore, the Treasury Department believed that it did not need to close insolvent S&Ls as long as they could get enough short-term deposits to continue business (Lowy; 1991, p. 20).

In February 1981, President Reagan nominated Richard Pratt, a noted tough-minded professor of finance from Utah, as Chairperson of the Bank Board (Mayer; 1993, p. 59). Pratt had been chief economist for the U.S. League and understood the issues of economic deregulation (Pilzer and Deitz; 1989, p. 71). Pratt put the problem in historical perspective at his Senate confirmation hearing. He listed the factors that "threaten to undermine the integrity" of the savings and loan industry:

> (1) The rapid escalation in institutions' cost of funds fueled by inflation and dramatic variations in interest rates is causing serious shortfalls in earnings.
>
> (2) The combination of deregulation and the natural competitive process in the market is forcing savings and loan associations to acquire an increasing portion of their funds at costly open market rates.
>
> (3) The growth of unregulated money market funds is causing rapid disintermediation (withdrawal of funds) and threatening the liquidity of thrift institutions, which cannot compete for consumer savings on an equal basis.
>
> (4) Low-yielding mortgage portfolios are not turning over returns as quickly as in the past, since inflation and high mortgage rates are encouraging borrowers to continue to hold their low-interest mortgages.
>
> (5) In short, savings and loan associations may very often be paying in excess of 15 percent for marginal funds, while their lending portfolios are yielding 9 percent or less.

> Even the most basic financial analysis of such a situation indicates a severe strain on liquidity, net worth, and earnings (Lowy; 1991, p. 35).

On April 16, 1981, the House and Senate confirmed Richard Pratt as the Bank Board Chairperson. Paraphrasing Winston Churchill, Pratt said: "I have not been appointed chairman to preside over the demise of this industry. We are going on to bigger and better things" (Robinson; 1990, p. 39). He declared that the primary thrust of his administration would be to expand the powers to S&Ls and reduce regulations (Lowy; 1991, p. 21).

During Pratt's first month in office, the Bank Board authorized all federally chartered S&Ls to participate in ARMs (Mayer; 1993, p. 61). ARMs had low "Teaser" introductory rates that made it easier for homebuyers to qualify for long-term mortgages (Robinson; 1990, p. 39). ARMs became popular with the industry because they allowed S&Ls to raise mortgage payments from homeowners to adjust for increases in interest rates. Thus, if Congress had allowed ARMs in 1976, the industry might have avoided the massacre of the Carter-Volcker years (Sherrill; 1990, p. 597).

In May 1981, interest rates increased to more than 16 percent, triple the level of five years earlier (Rom; 1996, p. 46). However, S&Ls paid an average of 10.31 percent for short-term deposits and earned an average of 9.72 percent on long-term mortgages (Pilzer and Deitz; 1989, p. 71). The discrepancy between the higher interest rates S&Ls paid for short-term deposits and the low interest rates they earned in long-term mortgages widened. The industry lost $1.5 billion in six months, more than 5 percent of their total net-worth (Pilzer and Deitz; 1989, p. 71). As a result, the S&L industry looked like this:

(1) Seventy-five percent of all federally chartered S&Ls were sure to lose money in 1981.

(2) About 50 federally chartered S&Ls were insolvent unless interest rates turned around and another 300 were sure to become insolvent in the next year.

(3) More than 1,000 federally chartered S&Ls could not meet traditional 5 percent net-worth requirements; 500 could not meet even a 3 percent requirement.

(4) The healthiest federally chartered S&Ls would be insolvent in less than two years if interest rates did not decrease.

(5) For these reasons, it was foreseeable that if traditional regulatory practices were followed, FSLIC would have to liquidate \$300-\$400 billion out of \$750 billion in industry assets at a net cost of 15 percent to 25 percent, for a total of \$45 billion to \$100 billion.

(6) The FSLIC fund had \$6 billion and \$750 million line of credit with the U.S. Treasury (Lowy; 1991, p. 35).

The Bank Board believed that consumers would lose confidence if the public knew the facts. The Bank Board's goal was to keep insolvent S&Ls in business by making them appear to have some net-worth, when in fact, they had none or significantly, less than the law required. Two hundred insolvent S&Ls required monetary assistance from the FSLIC (Lowy, 1991; Calavita, Pontell and Tillman, 1997). However, the industry was insolvent by \$150 billion (Pilzer and Deitz; 1989, p. 71).

Pratt stated, "At that rate of decline, the virtual elimination of the S&L industry is more than a theoretical possibility. Obviously, the 1980 legislation had not done its job" (Pilzer and Deitz; 1989, p. 72). Forbes Magazine observed, "You can't borrow at 12 percent to invest at 9 percent unless you are prepared to let your company go down the drain. However, that is exactly what's happening at many savings and loans" (Sloan; 1982, p. 83). However, Congress could not allowed the S&L industry to collapse because a massive default would have posed too much of a threat to the country's financial stability.

The Bank Board Push for New Deregulation Legislation

It was not until the deregulatory fervor of the early Reagan Administration that deregulation strategy gained political acceptance as a solution to the rapid escalation of the S&L crisis. The Administration believed that the "free enterprise" system worked best if left alone unhampered, by perhaps well meaning, but ultimately counter productive government regulations (Calavita, Pontell, and Tillman; 1997, p. 11). The constraints that bind the industry seemed to confirm the theory that government regulations imposed an unfair handicap in the competitive process.

The Housing Commission recommended a statement approving direct investments in real estate by federally chartered S&Ls. "Thrift institutions should be permitted to invest in real estate of various types only through service corporations or holding companies. The separation of real estate activities from the deposit-taking entity is necessary for the protection of federally insured deposits in these institutions" (Pilzer and Deitz; 1989, p. 73). Therefore, legislators told the S&Ls executives, "If you need to earn more money on investments, go out and invest in businesses that will earn you more money" (Pilzer and Deitz; 1989, p. 73). Therefore, Congress prescribed more deregulation when the DIDMCA did not work.

In October 1981, the Bank Board pushed for new legislation that would get insolvent S&Ls back to solvency. Pratt offered the Bank Board new powers that would make the industry more attractive such as demand deposits to any customer, corporations, and to make corporate, commercial and agricultural loans (Robinson; 1990, p. 40). Pratt believed that luring new private capital was the only way to re-capitalize the industry without enormous government assistance (Lowy; 1991, p. 46). Therefore, Pratt wrote the proposal that codified the new incentives the government gave the industry.

Utah's Republican Senator Jake Garn, Chairperson of the Senate Banking Committee and Representative St. Germain introduced the bill known as "The Pratt Bill" (Sherrill; 1990, p. 597). On the one hand, Senator Garn favored legislation that would restructure the S&L industry and make it more like commercial banks (Sherrill; 1990, p. 597). The thrust of Senator Garn's legislative proposal rested on forbearance, the official policy of encouraging regulators to tolerate problems and look the other way during hard times.

On the other hand, Representative St. Germain wanted to preserve the industry. He sought to maintain a semblance of the industry's original housing mission. Therefore, the Pratt bill went through Congress with few hearings in the Senate or the House Banking Committees (Day; 1993, p. 117). Representative St. Germain and Majority Leader Jim

Wright muscled into law the Garn-St. Germain Depository Institutions Act (Garn-St. Germain Act).

The Garn-St. Germain Act expanded the investment powers of federally chartered S&Ls further away from their traditional role as providers of long-term home mortgages. The Act allowed S&Ls to use short-term deposits it received for long-term mortgages and invest those funds in commercial real estate, or insubordinate debentures (junk bonds) (Pilzer and Deitz; 1989, p. 75). This policy had several goals for making S&Ls profitable:

(1) Increase S&Ls' consumer loans up to 30 percent of their assets, commercial, corporate or business loans.

(2) Offer certificates of deposit of $100,000 denomination free of withdrawal penalties and limits on interest rates, and a wide variety of other kinds of accounts

(3) Invest up to 40 percent (up from 20 percent) of the savings and loan assets in nonresidential real estate lending (e.g., shopping centers, condo, and apartment projects).

(4) Maintain a capital reserve of 3 percent.

(5) Remove requirement of down payments on loans from borrowers. S&Ls could finance up to 100 percent of a deal with borrowers not having paid a cent of their money on a loan.

(6) Transform S&Ls from mutual institutions to stock institutions in an effort to raise new capital.

(7) Remove requirement that S&Ls have at least 400 shareholders and no one shareholder could own more than 25 percent of the stock. This allows a single investor to own and operate a federally chartered S&L (Kane, 1989).

Thus, an entrepreneur could: (1) start or buy an S&L for $3 million, (2) attract $100 million in federally insured short-term brokered deposits by offering to pay 10 percent interest, (3) loan that $100 million by purchasing mortgage-backed securities paying 12 percent. If interest rates fell by 1 percent point, the $100 million mortgage-backed securities could be sold for $107 million or a profit of $71 million more than twice the S&L owner's original equity investment, (4) pocket $18 million in points and fees, (5) package the loans and sell them to other S&Ls, and (6) start all over (Ferguson; 1993, p. 127).

Moreover, the potential for profits was spectacular in junk bonds investments. An S&L owner could put $100 million of federally insured funds into higher-yield, higher-risk junk bonds paying 16 or 17 percent interest. The owner's entire $3 million investment could be repaid in the first six months and doubled every year thereafter. What an S&L owner had at stake was 3 percent of the $100 million (Pilzer and Deitz; 1989, p. 130). The Garn-St. Germain Act encouraged S&Ls to take excessive risks because the FSLIC would pick-up the pieces if the bonds became worthless (Greider; 1989, p. 29).

The financial difficulty that the S&L industry faced, could have increased the likelihood of decisions, which placed profitability ahead of the establishment of the Federal Home Loan Bank Act of 1933, the Home Owner's Loan Act of 1933, and the National Housing Act of 1934 that promoted the construction of new homes and protected the industry. This interpretation would be consistent with Marshall Clinard and Peter Yeager's findings, which suggest that the greater the financial strain faced by business, the greater the likelihood they will engage in regulatory violations (Clinard and Yeager, 1980).

Regardless of the new economic environment, the industry faced or its policies of the 1930s may have provoked, the Bank Board could have intervened in a way that would have protected Lincoln Savings from American Continental. What were the factors that disrupted the ability of the federal regulators to regulate the conditions at Lincoln Savings? There are two main issues. First, there is evidence to suggest that Congress dismantled the industry's regulatory infrastructure and relaxed regulations that made it possible for American Continental to commit criminal fraud at Lincoln Savings. Second, the Bank Board failed on two occasions to take unheeded warnings about real estate developers as proprietors of S&Ls.

The Dismantling of the S&L Industry's Regulatory Infrastructure

On October 15, 1982, President Reagan invited 200 people to the Rose Garden Ceremony to witness the signing of the Garn-St Germain Act. President Reagan recognized it as one of his administration's major pieces of deregulation legislation (Pizzo, Fricker, and Muolo; 1989, p. 1). He told the audience of S&Ls executives, bankers, Congressmen, and journalists that they were there to witness a major step toward the deregulation of America's financial institutions.

President Reagan promised the American people that he would get government "off their backs" by deregulating the private sector (Eichler; 1989, p. 36). He believed that government stifled businesses and taxpayers, and the economy would thrive if the dead hand of regulation were lifted from the enterprising spirit of the American people. He stated, "For 50 years, American families had relied on S&Ls to finance their homes, but outmoded regulations left over from the era of the Great Depression were preventing thrifts from competing in the complex sophisticated financial marketplace of the 1980s" (Rom; 1996, p. 47). "The Garn-St. Germain Act would cut savings and loan loose from the tight girdle of old-fashioned restrictive federal regulation" (Pizzo, Fricker, and Muolo; 1987, p. 1).

President Reagan further stated, "It is the most significant piece of banking legislation since 1933" (Lowy; 1991, p. 49). "It will mean more housing, more jobs, and growth for the economy" (Pizzo, Fricker, and Muolo; 1989, p. 1). "Garn-St. Germain puts thrifts back into the housing arena"(Rom; 1996, p. 274). "All in all, I think we've hit the jackpot" (Waldman and Thomas; 1990, p. 27). In a few bold strokes, policy makers dismantled most of the regulatory infrastructure that kept the S&L industry together for almost five decades. No longer were S&Ls committed to long-term, fixed interest rate, home mortgage loans (Cottrell and Lawlor, 1995). Therefore, Lincoln Savings became prime targets for fast-talking "High Roller" real estate developer, Charles H. Keating Jr., owner and Chief Executive Officer of American Continental Corporation, a real estate company based in Phoenix, Arizona (Calavita, Pontell, and Tillman, 1997).

Bank Board Warned of Problems

Known for big salaries and lavish spending in his days as C.E.O. of American Continental Corporation, Keating became a symbol of the savings and loan crisis of the 1980s. He grew up in a most intense S&L environment operated by German-Americans in Hamilton County of southern Ohio (Day; 1993, p. 129). He and his brother, William Keating, founded the prominent Cincinnati law firm of Keating, Muething and Klekamp (Adams; 1990, p. 238). As a lawyer, Keating bought S&Ls, sold S&Ls, and did work for and against S&Ls. For this reason, Keating's associate Michael Milken, "Junk Bond King" at Drexel Burnham Lambert (Drexel), learned that American Continental Corporation could make great profits from corporate bonds at marginal S&Ls that were candidates for corporate takeovers (Simon and Eitzen; 1993, p. 3).

Milken told Keating to buy an S&L located in California as a way to secure funds for American Continental (Pizzo, Fricker, and Muolo; 1989, p. 389). California had the most liberal laws in the country on investing federally insured funds (Long; 1993, p. 38). California's 1983 Nolan Law Act permitted owner of a state-chartered S&Ls to invest 100 percent of federally insured funds in real estate (Day; 1993, p. 210). Therefore, the S&L that caught Keating's attention was Lincoln Savings in Irvine, California.

In the early 1980s, Lincoln Savings faced the double-digit interest rate risk like most S&Ls. It was unprofitable and close to insolvency. Lincoln's portfolio had low-yield long-term mortgages of 6 to 8 percent. However, Donald Crocker, owner of Lincoln Savings, paid 15 percent interest rate to attract and keep short-term deposits (Day; 1993, p. 70). As a result, Lincoln's net-worth vanished because of the economic conditions.

In August 1983, Crocker received a phone call from an investment banker. The banker stated that he had a buyer for Crocker's stock at $16 a share. Lincoln Savings' stock traded at $8 a share, but Crocker was not interested (Day; 1993, p. 207). Lincoln Savings was a family business, with more than 40 percent of the shares in the hands of Crocker, his brother, and his two sisters (Mayer; 1993, p. 170). Two weeks later, Crocker received a call from a prominent Los Angeles lawyer who asked about selling Lincoln Savings. The lawyer told Crocker that he had a client who wanted to pay $16 a share or $40 million for Lincoln Savings (Day; 1993, p. 208). The lawyer revealed his client as Charles H. Keating Jr.

On September 23, 1983, Keating offered Crocker between $40 million and $50 million dollars for Lincoln Savings (Day; 1993, p. 208). Keating raised his price to $20 a share for Lincoln's stock. Keating told Crocker that he could raise $51 million through Drexel to buy Lincoln Savings (Pizzo, Fricker, and Muolo; 1989, p. 389). Crocker told Keating, "Even though he was the controlling shareholder, he had to discuss the deal with the other shareholders" (Day; 1993, p. 209). In addition, Crocker had a concern for his employees. He wanted to know how Keating would handle the personnel.

Keating promised Crocker that anyone who wanted to stay would be able to stay at Lincoln Savings (Mayer; 1993, p. 171). Keating promised to continue operating Lincoln Savings as a traditional thrift that specialized in home lending (Day; 1993, p. 209). Crocker decided that the deal might work. After meeting with Lincoln's officials and shareholders,

$50 million in cash was more than twice Lincoln's market value (Day; 1993, p. 209). Therefore, Crocker decided to sell Lincoln Savings to American Continental Corporation.

On September 30, 1983, Crocker and Keating signed a definitive agreement for the sale of Lincoln Savings (Day; 1993, p. 209). Drexel filed an underwriting of American Continental's stock to the Securities Exchange Commission (SEC). Drexel claimed that American Continental described itself as the largest homebuilder in Colorado, Arizona, and the seventh largest homebuilder in the country (Mayer; 1993, p. 172).

However, federal regulators worried about real estate developers as proprietors of S&Ls (Mayer; 1993, p. 169). James Corona, president of the Federal Home Loan Bank (FHLB-SF) in San Francisco, was reluctant to proceed on the sale of Lincoln Savings to American Continental. Corona warned the Bank Board about American Continental Corporation as a proprietor of Lincoln Savings:

> First, there was no evidence of any S&L industry experience among the senior officers of American Continental Corporation. Second, being an out-of-state entity raised concerns of federally insured funds flowing from California to support activities that would not benefit the association's local community. Finally, supervisory problems had already become apparent with firms associated with real estate development corporations owning savings and loans (Mayer; 1993, p. 170).

However, American Continental addressed those concerns through a new application. Keating promised the Bank Board that he would keep the current Lincoln Savings' senior management subsequent to acquisition. He stated that American Continental would not interrupt the association's current program of community home lending in Southern California. He gave assurance that American Continental would not violate any regulations pertaining to affiliated transactions. Finally, Keating promised that Lincoln Savings would obtain funds through short-term deposits and not brokered funds (Lowy; 1991, p. 97). Therefore, with these reassurances without imposing any special controls, American Continental won the approval from the SEC for the purchase of Lincoln Savings.

Overall, the evidences suggest that Congress dismantling the S&L industry's regulatory infrastructure and the Garn-St. Germain Act allowed American Continental to buy Lincoln Savings. Furthermore, the regulators had concerns about American Continental as owner of Lincoln Savings. In addition, the evidence suggests that there was no S&L experience among senior officers of American Continental. There were concerns about American Continental removing federally insured funds from California to support activities that would not benefit the community. Finally, there had been prior problem with S&Ls associated with real estate development corporations that own S&Ls.

This represented a critical organizational flaw in the S&L industry where Keating address the regulator's concerns through a new application. In the *Lincoln Savings & Loan Scandal*, this flaw was a significant factor in several fraudulent investments and 23,000 Lincoln Savings' members who invested $250 million in worthless junk bonds.

The Failure of the Federal Home Loan Bank Board

The Bank Board had a specific reason to deny American

Continental access to Lincoln Savings. In 1979, the SEC brought forth a civil fraud suit against Keating, Muething, and Klekamp (Adams; 1990, p. 239). American Financial Corporation, a Cincinnati conglomerate owned by Carl H. Lindner. The SEC alleged that Keating and Lindner fraudulently converted $14 million in assets for their personal use and made improper loans on preferential terms to American Financial Corporation insiders (Jeffrey; 1990, p. 18).

Keating and Lindner settled and signed a consent cease-and-desist decree (Kelly; 1987, p. 80). The consent decree meant that both men entered no defense without admitting guilt and agreed not to violate the law in the future. However, such an agreement allowed the corporation to avoid admitting fault in future civil suits by private citizens (Pepinsky and Jesilow; 1992, p. 65). The evidence suggests that the consent decree and regulators' concerns did not prevent the sale of Lincoln Savings to American Continental.

On February 22, 1984, the Bank Board and California State Regulator Lawrence Taggart approved the change of control for Lincoln Savings to American Continental (Day; 1993, p. 209). Keating paid Crocker $51 million for the purchase of Lincoln Savings (Yang, 1990; Simon and Eitzen, 1993). The transaction increased Lincoln's regulatory capital over $96 million, and its net-worth was $54 million (Lowy; 1991, p. 147). Therefore, American Continental had its hands on Lincoln Savings' $1 billion in federally insured funds (Rudnitsky; 1989, p. 142). Consequently, the failure of the Bank Board, and the SEC to prevent the sale of Lincoln Savings set the stage for the crime to follow.

CHAPTER 4

THE LINCOLN SAVINGS & LOAN SCANDAL

A competitive economy dominated by a profit-seeking corporation, a government committed to offering an attractive profit-making environment, the dismantling of the S&L industry's infrastructure, regulatory agencies' who failed to protect the S&L industry, and five U.S. Senators with political power to influence the regulatory structure of the industry, all contributed to the *Lincoln Savings & Loan Scandal.* However, these events alone did not cause the scandal. Therefore, it is important to examine the ways in which the activities of the Bank Board intersected with the activities of American Continental. The scandal may have resulted from action taken by management at American Continental and Lincoln Savings, but the failure of several government regulatory control agencies made those actions possible.

In the case of the *Lincoln Savings & Loan Scandal*, the critical intersections were between several government agencies and private business. At involved the federal level, the Federal Home Loan Bank Board, the San Francisco Federal Home Loan Bank, the Federal Enforcement Review Committee. At the state level, involved was the California State Regulatory Agency. In the private business sector involved American Continental Corporation. By omission, each of these state agencies failed to perform the control functions assigned to them that made it possible for the continuation of fraudulent investments at Lincoln Savings that led to criminal fraud. Therefore, this case study will examine the details of the scandal and then discuss the way in which each control failed within the specific context of American Continental's operation of Lincoln Savings.

The Lincoln Savings & Loan Scandal

In order for the Bank Board to protect Lincoln Savings and its members, the Bank Board should have recognized the problems that could have happen if American Continental took possession of Lincoln Savings. The evidences in the *Lincoln Savings & Loan Scandal* indicate that the significant changes of the Garn-St. Germain Act allowed American Continental to make a host of fraudulent investments in commercial loans with federally insured funds.

In September 1984, immediately after American Continental Corporation acquired Lincoln savings, Keating violated the assurances that induced approval of the sale from the Bank Board and the California Savings and Loan Commission (Morganthau and Clift; 1989, p. 35). Despite Keating's promises, he fired all of Lincoln's senior management. He claimed that he had to dismiss the executives because they were incompetent (Lowy; 1991, p. 97). Thus, he replaced them with American Continental staffers who had no banking experience to operate Lincoln Savings.

In addition, Keating changed the course of Lincoln Savings and transformed it from a traditional home mortgage lender into a hodgepodge of risky investments (Mayer; 1993, p. 171). American Continental invested $2.7 billion in junk bonds, $20.7 million in commercial real estate projects and in several corporate subsidiaries to increase Lincoln

Savings' profits (Adams, 1990; Mayer, 1993). Furthermore, Keating booked a spurious earning for American Continental on a real estate project called rancho Vistoso, in Tucson, Arizona. Lincoln Savings lost $75 million on the $115 million it lent on the project (Long; 1993, p. 38). Finally, American Continental's largest land-development project was 29,000 acres of desert called Estrella housing sub-division, west of Phoenix near Goodyear, Arizona (Pizzo and Muolo; 1993, p. 109). Keating pronounced that when he finished this project, "He would have fathered a new city of 200,000 people" (Wilmsen; 1991, p. 130). However, real estate experts judged Estrella's potential might take ten to fifteen years to develop and would probably make back only half its projected costs (Seidman; 1993, p. 231).

American Continental's most expensive venture was a $300 million opulent resort hotel, The Phoenician, located in Scottsdale, Arizona (Binstein and Bowden; 1993, p. 39). The Phoenician boasted of the lavish appointments found in Europe's most celebrated resorts blended with the style and ambience of the great American Southwest. The Phoenician rose from the base of Camelback Mountain, amidst 130 acres of sparkling pools, fountains, waterfalls, lush landscaping, capacious comfort, and exquisite dining. The main lobby presented its stately marble, Italian crystal chandeliers, and compelling valley view at one of the premier resorts in the world. The Phoenician was one of the world's most distinctive resorts situated in the Valley of the Sun (Seidman; 1993, p. 231).

In addition, to build the Phoenician's six-hundred-room resort was a record cost of $500,000 per room (Day; 1993, p. 209). Four hundred and forty-two roomy guestrooms, each averaging 600 square feet, one hundred and seven elegant casitas, thirty-one luxurious suites, including two 3,2000 square feet Presidential suites (Seidman; 1993, p. 230). Its opulence guaranteed it was never going to be profitable unless the hotel could charge the unattainable sum of $5,000 a night for every room in the hotel (Seidman; 1993, p. 230). The standard guideline for hotel rates is that the nightly room charge should be one percent of the total capital costs of a room. The Phoenician's rooms each cost $500,000, so the hotel had to average $5,000 a night for a least 70 percent of the year to make money (Seidman; 1993, p. 230). It is the most costly and luxurious hotel ever built in the United States (Seidman; 1993, p. 230).

Apparently, the network of federal regulators never made follow-up checks to see if Keating kept his word to Crocker. If the San Francisco regulators had done a follow-up, it would have seen that from the very beginning American Continental was out of control. Because of American Continental's new ventures, Lincoln Savings became the leading opponent of the new Bank Board's proposal to limit direct investments by state-chartered S&Ls.

The Bank Board's new Chairperson, Edwin Gray, saw that Lincoln Savings' direct investments were risky, and the industry could not afford additional risks. Therefore, Gray launched a regulatory counter offensive. He proposed a new capital regulation aimed at preventing state-chartered S&Ls from investing over 10 percent of their assets in direct investments (Dwyer, 1989; Lowy, 1991). The direct investment-rule (equity rule) imposed by the Bank Board was a way of limiting Lincoln Savings' exposure to financial risk. Thus, the limit was a direct threat to American Continental's plan for Lincoln Savings' funds guaranteed under the California's Nolan Act of 1983. Therefore, Keating was quick to respond to the new regulatory threat.

In September 1985, Keating made his next move between American Continental and Lincoln Savings to avoid the new equity rule. American Continental found a legal way around the Bank Board's new regulation. Keating created a maze of subsidiaries that made it difficult, if not impossible, to trace where American Continental invested Lincoln Savings' federally insured funds.

Crescent Hotel Group of Michigan, Inc. (CHG/M), a subsidiary of Lincoln Savings, bought the Hotel Pontchartrain, a 422 unit-hotel in downtown Detroit, for $19.5 million dollars (Binstein and Bowden; 1993, p. 55). Keating formed Hotel Pontchartrain Limited Partnerships (HPLP) as a subsidiary of American Continental. HPLP bought the Hotel Pontchartrain from CHG/M. Lincoln Savings loaned $38 million to one of its subsidiaries, Lincoln Commercial Properties (LCP), which loaned the $38 million to CHG/M. HPLP then borrowed $38 million from CHG/M in order to buy the hotel from CHG/M (Binstein and Bowden; 1993, p. 56).

Through a series of transactions, American Continental loaned $38 million of Lincoln Savings' money to buy the Hotel Pontchartrain. If Lincoln Savings put $38 million directly into the Hotel Pontchartrain, this would be illegal as self-dealing. However, the loan enable American Continental to repay $10 million that Lincoln Savings had previously advanced to the partnership to service the debt of Hotel Pontchartrain and to obtain $3.8 million in tax benefits (Long; 1993, p. 39).

In December 1985, Lincoln Savings avoided the equity rule by swapping loans between American Continental and Southmark Corporation. American Continental loaned $129 million to Southmark and its subsidiary, San Jacinto Savings & Loan Association in Houston, Texas (exceeding the loans-to-one-borrower [LTOB] limit). Not only did this net American Continental handsome up front fees, points, and dividends, but also Southmark returned the favor. Southmark loaned American Continental $35 million for its projects (Calavita, Pontell, and Tillman; 1997, p. 26). Because of loan swapping, American Continental and Southmark exchanged about $246 million in existing mortgages. American Continental booked $12 million in profits from the swaps (Pizzo, Fricker, and Muolo; 1989, p. 400).

In addition, Lincoln Savings swapped real estate between American Continental and Mizell Development Corporation (MDC) to avoid the equity rule. MDC was a real estate subsidiary of Denver's Columbia Savings & Loan Association, (an associate of Southmark subsidiary). American Continental and MDC worked together to trade land parcels back and forth. Lincoln's subsidiary AMCOR bought 6,000 undeveloped home sites from MDC. In turn, MDC received a $75 million line of credit from Lincoln Savings and bought nearly 4,000 undeveloped home sites from AMCOR (Wilmsen; 1991, p. 130). These procedures protected the value of bad loans known as "trading the dead horse for the dead cow" (Mayer; 1993, p. 70). These trades generated spurious profits and gave appraisers a pretext to increase appraised values of land in that neighborhood.

Meanwhile, Arthur Andersen Accounting firm [The accounting firm involved in the Enron Scandal] learned that federal regulators were on their way to Lincoln Savings for a scheduled examination. The firm dispatched a team of auditors to Lincoln Savings to falsify, backdate, or "stuff files" with documents considered vital to Lincoln's investments (Davis; 1997, p. 31). For instance, if a loan lacked documentation, underwriting, and appraisals, this meant the employees must correct it to regulators' standards. If a direct investment was in excess of the new equity rule, this meant that employees must fine a way to characterize it as a loan and not a direct investment. If a deal involved executives at American Continental, regulators viewed Lincoln Savings' activities as illicit insider trading or self-dealing. This meant that American Continental must restructure Lincoln Savings through subsidiaries to avoid self-dealing (Binstein and Bowden; 1993, p. 221).

On March 12, 1986, FHLB-SF regulators became wary of Lincoln's explosive growth and began their scheduled examination at Lincoln Savings (Adams; 1990, p. 243). Regulators suspected that American Continental made too many risky investments with Lincoln Savings' federally insured funds (Day, 1993; Calavita, Pontell, and Tillman, 1997). By July 1986, regulators uncovered 54 loans and investments without supporting credit reports or analysis on borrowers. These loans and investments were in violations of federal law (Borger and Hedges; 1989, p. 21).

Furthermore, regulators discovered that American Continental and Arthur Andersen's employees collaborated in "stuffing files" (Mayer; 1993, p. 191). The employees crammed files with backdated documents that intended to mislead and defraud regulators. They gave many conflicting reasons for their state of affairs. However, the most persuasive explanation came from Lincoln's in-house legal counsel, Mark Sauder. Sauder stated, "The cut and pasted documents had been put in the files for examiners to find and for no other reason" (Davis; 1997, p. 35). Therefore, this act was a criminal violation of federal law.

In October 1986, regulators determined that Lincoln Savings had behaved as if the equity rule did not exist. They discovered that Lincoln Savings had $135 million in unreported losses on loan swaps that generated paper profits. Specifically, the audit showed that Lincoln Savings had broken the 10 percent equity rule by $615 million (Morganthau and Clift, 1989; Adams, 1990). There was evidence that loans, real estate investments, and purchases of junk bonds accounted for 62 percent of Lincoln's assets (Lowy; 1991, p. 147). Clearly, this was in violation of the equity rule.

The regulators finished their examination of Lincoln Savings and concluded that the underwriting for these investments were deficient, nonexistent, and fraudulent (Jeffrey; 1990, p. 19). Lincoln's losses stemmed from over-appraisals of property values and direct equity investments that failed. The regulators recommended that the Bank Board close Lincoln Savings (Borger and Hedges; 1989, p. 19). However, Keating and his lawyers accused the bank examiners of being biased and forced the examiners to justify every detail of their report. Keating stated, "He would fight to service the Hotel Pontchartrain, The Phoenician Hotel, and the Estrella Sub-division, which all lost money (Binstein and Bowden, 1993; Day, 1993; Mayer; 1993). Therefore, Keating contacted five United States Senators to intervene in the closing of Lincoln Savings.

Keating called on Senator Dennis DeConcini (D-Arizona), Senator Donald Riegle (D-Michigan), Senator Alan Cranston (D-California), Senator John Glenn (D-Ohio), and Senator John McCain (R-Arizona). Keating asked the Senators to intervene with federal regulators to prevent them from closing Lincoln Savings for its direct investments. He told the Senators that the Bank Board's equity rule represented a change in policy that unfairly hurt American Continental and Lincoln Savings (Day; 1993, p. 262). He wanted them to protect Lincoln Savings and get Gray and regulators "off his back" (Mayer, 1993; Seidman, 1993).

Campaign disclosure forms provided a rare insight into the methods of fund-raising by the five Senators. They received substantial campaign contributions from American Continental Corporation. Since 1984, the Senators received approximately $1.9 million in campaign contributions from American Continental (Clift, 1989; Adams; 1990). Senator DeConcini received $55,000 (Pizzo, Fricker, and Muolo; 1989, p. 290). Senator Cranston received $39,000 for his 1986 campaign, $850,000 for three voter education projects, and $85,000 for a California Democratic Party voter drive (Dwyer, 1990; Pizzo, Fricker, and Muolo, 1989; Day, 1993).

In addition, Senator Cranston received $400,000 for a get-out-and-vote fund (Dwyer, 1989; Adams; 1990). Senator McCain received $112,000. In addition, he received nine private plane trips worth $13,433 to the Bahamas from 1984 through 1986 (Day; 1993, p. 262). Senator Glenn received $234,000 (Day; 1993, p. 262). Senator Riegle received $76,100 (Carlson; 1989, p. 27). Thus, Keating claimed, "American Continental Corporate contribution's support and campaign for the political leaders we believe represent the best of American virtues" (Jeffrey; 1990, p. 20).

The evidence suggests that the intervention of the Senators restrained the Bank Board and federal regulators from taking action against Lincoln Savings. In March of 1987, Ed Gray visited with Senator Riegle at his Capitol Hill office. Gray hoped to persuade Senator Riegle, (who was heir apparent to retiring Senate Banking Chairperson Proxmire), to support a bill to re-capitalize the FSLIC. Gray attempted to raise new resources for the FSLIC re-capitalization plan stalled in the House by the opposition Majority Leader Jim Wright (Mayer; 1993, p. 198). Gray hoped to get enough money to pay off the brokered deposits and close down the worst S&L disasters in Texas and California. The Senate would have voted for major re-capitalization plan and demanded that the House go along with the plan (Mayer; 1993, p. 1998).

However, Senator Riegle had other business in mind. At the end of the meeting, he pulled Gray aside and asked if he would meet alone with a group of Senators who were upset with the Bank Board's treatment of Lincoln Savings' examination. Gray protested, but the antagonism of the

Senators could be fatal to his plans. Gray felt that he could confront the Senators. However, he needed their votes in the Senate to obtain new funds for the failing FSLIC (Seidman; 1993, p. 233). Gray could not afford to anger members of Congress when he wanted $15 billion for the re-capitalization plan (Binstein and Bowden; 1993, p. 284). Thus, Senator Riegle's persistence culminated in the famous meetings between Gray, San Francisco regulators, and five Senators who became the "Keating Five" (Day; 1993, p. 263).

On April 2, 1987, Gray arrived alone at the Senator Riegle's office, and he was ill prepared to face the hostile audience. He was stunned to see Senator Cranston, Senator Glenn, Senator DeConcini, and Senator McCain without their staff, an unusual occurrence since Senators seldom meet outsiders without aides present (Pizzo, Fricker, and Muolo; 1989, p. 290). Senator DeConcini complained about the examination of Lincoln Savings and the equity rule. "We're here on behalf of "our friend" at Lincoln Savings and are concerned that a regulation that the Bank Board adopted is unconstitutional" (Day; 1993, p. 263). "Our friend at Lincoln Savings had relayed these concerns to us" (Adams; 1990, p. 244). "Look, this is what we'll do. We agree with the idea that Lincoln Savings is not making home loans is bad" (Pizzo, Fricker, and Muolo; 1989, p. 290). Therefore, Senator DeConcini offered a quid pro quo. "We assure you that 'our friend' will make more home loans and get into the basic business of home lending if you do something. You have to withdraw the equity risk regulation" (Jeffrey; 1990, p. 20).

Gray believed the idea of a quid pro quo was bizarre. He never had been asked until this meeting by any U.S. Senator to withdraw a regulation for any reason, particularly on behalf of a "friend," especially, in the privacy of a senatorial office (Adams; 1990, p. 244). Gray implied that it would be improper to ask about specific negotiations with Lincoln Savings or about any arrangement the Senators tried to promote for their "friend" (Day; 1993, p. 264). Furthermore, Gray offered his opinion that it was highly irregular for him, as the Bank Board chairperson, to be asked to discuss a savings and loan that was presently being examined by regulators (Pizzo, Fricker, and Muolo; 1989, p. 366). He explained, "If they had any more questions about Lincoln Savings, contact Jim Cirona, president of the Federal Home Loan Bank in San Francisco" (Pizzo, Fricker, and Muolo; 1989, p. 291).

On April 9, 1987, the Keating Five summoned the field regulator officials from San Francisco to Washington, D.C. Senator DeConcini called Cirona and asked if he and his staff would discuss "The Lincoln Problem" (Pizzo, Fricker, and Muolo; 1989, p. 291). Cirona agreed. The FHLB-SF personnel were Cirona, president; Michael Patriarca, Director of Agency Functions; and Richard Sanchez, Supervisory Agent for Lincoln Savings.

Anne Sobol, a lawyer for the Bank Board, and Bill Black, FSLIC Deputy Director, met the regulators. Sobol told Cirona that she would forward a criminal referral to the U.S. Department of Justice for American Continental alleged "stuffing files" and falsifying documents on direct investments uncovered in Lincoln Savings' 1986 audit (Binstein and Bowden; 1993, p. 288). After the regulators planned their strategy, Black escorted the regulators to Senator DeConcini's office for the confidential six o'clock meeting.

Present were Senator McCain, Senator Glenn, and Senator Riegle (soon to be chairperson of the Senate Banking Committee). Senator Cranston arrived at Senator DeConcini's office, "I'm sorry I can't join you, but I have to be on the floor to deal with a bill" (Pizzo, Fricker, and Muolo; 1989, p. 394). "I just want to say that I share the concerns of the other Senators on this subject" (Binstein and Bowden; 1993, p. 289). Each Senator claimed their "friend" as his personal constituent. They stated that Lincoln Savings location was in Irvine, California, American Continental Corporation was a Cincinnati, Ohio-chartered Corporation, and American Continental Corporation's headquarters was in Phoenix, Arizona (Pizzo, Fricker, and Muolo; 1989, p. 290). Black took detailed notes, which became an unofficial transcript of the meeting (Pizzo, Fricker, and Muolo; 1981, p. 291).

Senator DeConcini started with a strong defense of Lincoln Savings. "We wanted to meet with you because we have determined that potential actions of yours could injure a constituent. This is of particular concern to us because Lincoln Savings is willing to take substantial actions to deal with what we understand to be your concerns. "Lincoln is a viable organization. It made $49 million last year, even more the year before" (Adams; 1990, p. 245). "Lincoln is prepared to go into a major home loan program for 55 percent of its assets" (Pizzo, Fricker, and Muolo; 1989, p. 291).

Senator DeConcini continued with Keating's complaints. "Lincoln

Savings have two major disagreements with you. First, it is with regard to direct investments. Second, it is your reappraisal. They are suing against your direct investment regulation. We suggest that the lawsuit be accelerated and you grant them forbearance while the suit is pending" (Pizzo, Fricker, and Muolo; 1989, p. 292). "I know something about the appraisal values. They appear to be grossly unfair. I know the particular property here [The Phoenician Hotel]. Lincoln Savings is prepared to reach a compromise value with you" (Mayer; 1993, p. 199).

Senator Glenn stated, "American Continental Corporation is an Ohio-chartered corporation. I've known them for a long time, but it wouldn't matter if I didn't" (Pizzo, Fricker, and Muolo; 1989, p. 394). "Why has the exam dragged on and on? Ordinary exams take maybe up to six months" (Adams; 1990, p. 245). "Even the Arthur Andersen Accounting firm says you've taken an unusually adversarial view toward Lincoln. To be blunt, you should charge them or get off their backs" (Mayer; 1993, p. 199). "I'm not trying to get anyone off. If there is wrongdoing, I am on your side. But, I don't want any unfairness against a viable entity" (Pizzo, Fricker, and Muolo; 1989, p. 396).

Senator Riegle stated, "The appearance from a distance is that this thing is out of control and has become a struggle between Keating and Gray, two people I gather who have never met. The appearance is that it is a fight to the death. This discredits everyone if it becomes the perception" (Adams, 1990; Mayer, 1993). "If there are fundamental problems at Lincoln, OK. I just want to make sure the regulators are acting in a fair and professional manner" (Pizzo, Fricker, and Muolo;

1989, p. 396).

The regulators came to the meeting prepared with evidence that the Bank Board should take Lincoln Savings away from American Continental because it had become a rogue institution operating in an unsafe and illegal matter. Cirona put the Senators on notice. "This meeting is very unusual to discuss a particular company" (Pizzo, Fricker and Muolo; 1989, p. 292). Cirona took the offensive. "We [the San Francisco FHLB] determine how examinations are conducted. Gray never gave me instructions on how to conduct this exam or any other exam. We wanted Lincoln Savings in line with Gray's new direct-investment regulation" (Pizzo, Fricker, and Muolo; 1989, p. 292).

In addition, Cirona wanted Lincoln Savings to make more home loans. "Lincoln Savings had been a heavy single-family mortgage lender. In 1983, residential loans had been more than 30 percent of Lincoln's assets" (Day; 1993, p. 209). However, in 1985 and early 1986, Lincoln Savings originated only eleven home loans. Four were for employees and seven other on property owned by Lincoln Savings" (Day; 1993, p. 209). Cirona claimed, "For a $3.6 billion savings institution with 24 branch offices, it was unusual behavior" (Pizzo, Fricker, and Muolo; 1989, p. 290).

Richard Sanchez presented the Bank Board's case on the factitious appraisals or with no appraisal at all. Sanchez contended that Lincoln Savings exaggerated the value of properties in which American Continental had invested or made loans. "Our 1984 examination [of Lincoln] showed significant appraisal deficiencies. Mr. Keating promised to correct the problem. Our 1986 exam showed that he had not corrected the problems, and there were huge appraisal problems" (Pizzo, Fricker, and Muolo; 1989, p. 292). Sanchez cited one appraisal redone for the FHLB-SF by Merrill Lynch. "We have independent appraisals. Merrill Lynch appraised The Phoenician Hotel. It shows a significant loss" (Pizzo, Fricker, and Muolo; 1989, p. 292). "The Phoenician project lost over $100 million" (Lowy; 1991, p. 147). "These underwriting practices violate our regulatory guidelines," (Adams; 1990, p. 246).

In addition, Sanchez told the Senators, "Lincoln had underwriting problems with all their investments, equity securities, debt securities, land loans, and direct real estate investments" (Pizzo, Fricker, and Muolo; 1989, p. 292). He said, "Out of 52 real estate loans Lincoln Savings made between 1984 and 1986, there were no credit reports in the file on the borrowers in all 52 cases" (Adams; 1993, p. 246). "Examiners found $47 million in loans made to borrowers who did not have adequate credit to assure repayment" (Pizzo, Fricker, and Muolo; 1989, p. 293).

The Senators continued to advocate for Lincoln Savings. Glenn said, "Some people don't do the kind of underwriting you want." "Is their judgment good"? Michael Patriarca responded, "That approach might be okay if they were doing it with their money. They are not. They're using federally insured deposits" (Adams; 1993, p. 246). Senator Riegle objected, "Where's the smoking gun? "Where are the losses" (Adams; 1993, p. 246)? Senator DeConcini said, "What's wrong with this if they're willing to clean up their act" (Adams; 1993, p. 246)? Cirona replied, "This is a ticking time bomb" (Adams; 1993, p. 247).

However, the Keating Five continued to defend Lincoln Savings.

The following exchange between Senator Glenn and Patriarca altered the entire tone of the meeting:

PATRIARCA:	They're flying blind on all their different loans and investments. I am relatively new to the savings and loan industry, but I never have seen any bank or S&L that is anything like this. This is not even close. You can ask any banker you know about these practices. They [Lincoln's practices] violate the law, regulations, and common sense.
GLENN:	What violates the law?
PATRIARCA:	Their direct investments violate the regulation. Then there is the file stuffing. They took undated documents purporting to show underwriting efforts and put them into the files sometimes more than a year after they made the investment.
GLENN:	Have you done anything about these violations of law?
PATRIARCA:	We are sending a criminal referral to the Department of Justice. Not maybe, we are sending one. This is an extraordinarily serious matter. It involves a whole range of imprudent actions. I cannot tell you strongly enough how serious this is. This is not a profitable institution. Prior year adjustments will reduce that reported $49 million profit. They did not earn $49 million. Let me give you one example. Lincoln Savings sold a loan with recourse (i.e., the buyer could sell it back at the same price at any time) and booked a $12 million profit. The buyer rescinded the sale, but Lincoln Savings left the $12 million profit on its books.
DECONCINI:	Why do Lincoln's auditors continue to vouch for their books? Do you believe they [private accounting firms] would prostitute themselves for a client?
PATRIACRA:	Absolutely. It happens all the time.
RIEGLE:	Is this institution so far gone that it can't be salvaged?

PATRIACRA: I do not know. Lincoln Savings had $103 million in goodwill (what a business says it customer's support is worth) on their books. If this were backed out, they would have been $78 million insolvent.

CIRONA: The regulators had tried to compromise with Keating. I never have seen such cantankerous behavior. At one point, they said our examiners could not get any association documents unless they made the request through Lincoln's New York litigation counsel.

GLENN: What can we say to Lincoln?

PATRIARCA: I think my colleague Mr. Black put it right when he said that it is as if these guys put it all on 16 black in roulette. Maybe they will win. However, I can guarantee you that if an institution continues such behavior it will eventually go bankrupt.

DECONCINI: Frankly, the criminality surprises me. I am sorry, but I really do have to leave now (Pizzo, Fricker, and Muolo; 1989, p. 294).

The meeting ended. The regulators left angry. Patriarca stated, "We spent six months inside Lincoln looking at the books, and these guys were telling us there's nothing wrong" (Borger and Hedges; 1989, p. 21). The Keating Five, counted American Continental amongst their biggest political contributors, attempted to persuade regulators to look the other way while American Continental continued to violate federal laws and regulations at Lincoln Savings. However, the regulators had strong evidence of more than negligence, and deception; they had evidences of illegal activity at Lincoln Savings.

On May 1, 1987, regulators completed their 285-page report of Lincoln Savings (Lowy; 1991, p. 219). They concluded, "Keating recklessly and fraudulently ran Lincoln Savings into the ground, reaping

$34 million for American Continental Corporation" (Rudnitsky; 1989, p. 140). They considered Lincoln Savings to be the biggest scandal of all time (Adams; 1993, p. 248). Regulators compiled evidence of substantial irregularities to justify seizing Lincoln Savings. The FHLB-SF Eleventh District's examination stated:

> (1) Lincoln Savings never made a profit except by trading bad loans and securities.
>
> (2) The trading profits were bleeding Lincoln's future ability to make money.
>
> (3) Sixty-two percent of Lincoln's assets were risky investments in vacant land, hotels, ADC loans, junk bonds, and equity securities.
>
> (5) Lincoln Savings had enormous interest rate risk as well as credit risk.
>
> (6) Lincoln Savings made loans that were too large for its size and capital position.
>
> (7) Lincoln Savings violated the direct investment regulation by at least $600 million and was still at it.
>
> (8) Lincoln's management had violated representation after representation to the Bank Board and therefore could not be trusted.
>
> (9) Lincoln's filed reports consistently overstated its income (Lowy; 1991, p. 219).

Furthermore, regulators alleged that American Continental used a network of subsidiaries to mask debt and avoid the equity rule to make Lincoln Savings appear profitable (Binstein and Bowden; 1993, p. 56). However, the regulators failed to seize Lincoln Savings from American Continental. Instead, they suggested two recommendations. The first plan would place Lincoln Savings in conservatorship. Even though Lincoln Savings was insolvent, a conservatorship continues to make loans and take short-term deposits in attempt to make Lincoln Savings lucrative. The second plan would place Lincoln Savings in receivership. Receivership was the S&L's version of bankruptcy proceedings. The receivership would close Lincoln Savings and pay off stockholders (Pepinsky and Jesilow; 1992, p. 73).

Meanwhile, Keating kept channeling federally insured funds from Lincoln Savings into American Continental (Taylor; 1988, p. 38). He boosted Lincoln's capital by selling junk bonds that masqueraded as federally insured certificates of deposit (Adams, 1990; Day, 1993). An advertisement appeared in the *Los Angeles Times* touting an investment opportunity (Binstein and Bowden; 1993, p. 66). Lincoln Savings offered American Continental's high-yield junk bonds. The bonds sold in $1,000 denominations and paid higher interest than federally insured certificates of deposit (Mayer; 1993, p. 167). American Continental paid 9.5 percent to 12 percent on a minimum investment of $2,000 for five years compared to banks' certificates of deposit that average 7.8 percent for one year and 8.3 percent for five years (Taylor; 1988, p. 38).

Keating told Lincoln's employees to use sophistry to persuade members to move their money from federally insured accounts to buy American Continental's junk bonds (Seidman; 1993, p. 235). The selling technique was bait-and-switch. Member Ramona E. Miller-Jacobs was a victim of the bait-and-switch. She went to the Burbank, California, branch of Lincoln Savings, looking for a safe place to put her daughter's

$11,000 (Dwyer; 1989, p. 26). The money was part of an insurance settlement from an accident that had left her daughter paralyzed. Miller-Jacobs said, "An employee at Lincoln Savings pressured her to put the money into the unsecured high-yield junk bonds instead of her federally insured account " (Dwyer, 1989; Giltenan, 1991). The employees never mentioned that the federal government did not insure her funds.

The employees used the bait-and-switch strictly to deceive investors. Many Lincoln's members believed that since Lincoln Savings sold the bond, they thought the government backed the bonds with full faith and credit (Coleman; 1994, p. 30). As a result, Lincoln's personnel illegally sold $250 million of unsecured junk bonds to 23,000 unsuspecting investors, mostly Senior citizens living on fixed income (Cope and Talley; 1994, p. 1). Regulators pledged to pursue whether American Continental defrauded Lincoln's investors (Cope and Talley; 1994, p. 1).

At the same time, Keating sensed that the federal regulators were very near to take control of Lincoln Savings. If the federal government seized Lincoln Savings, American Continental would declare Chapter 11 bankruptcy protection. This would build a legal wall between American Continental's assets and the federal government. However, if American Continental goes bankrupt, it would default on the $250 million of junk bonds owned by 23,000 Lincoln's investors (Binstein and Bowden; 1993, p. 350).

On April 13, 1989, Keating filed Chapter 11 bankruptcy protection for his entire $7 billion Corporation (Sloan and Taylor; 1988, p. 35). By law, Lincoln Savings could not claim the Chapter 11 protection (Mayer;

1993, p. 287). However, Lincoln's corporate subsidiaries failed under the bankruptcy protection. Therefore, in a last maneuver, Keating took $400 million in assets out of Lincoln Savings and sheltered them in eleven of American Continental's subsidiaries (Adams; 1990, p. 252). Keating's key purpose for placing American Continental in Chapter 11 Bankruptcy protection was to keep The Phoenician Hotel out of the federal government's hands (Day; 1993, p. 343). However, the junk bonds defaulted and twenty-three thousands investors became victims of the *Lincoln Savings & Loan Scandal* (Borger and Hedges; 1989, p. 24).

On April 14, 1989, the FSLIC declared Lincoln Savings insolvent, and placed it in conservatorship [ward of the federal government] (Rom; 1996, p. 243). Cirona and his staff presented to Bank Board officials in Washington, D.C., the first government document of the scandal specifying Lincoln Savings' estimated loss of $3.9 billion of federally insured funds (Yancey; 1990, p. E1). Thus, American Continental's bankruptcy became the subject of a criminal investigation.

Regulators investigated whether American Continental used fraudulent activities in Lincoln Savings' direct investments and if American Continental defrauded investors by concealing information about the unsecured junk bonds. Cirona filed a criminal referral that alleged Keating of using sophistry, machinations, and fraudulent activities to obtain federally insured funds from Lincoln Savings to maximize American Continental Corporation's profits (Rudnitsky; 1989, p. 140). Cirona forwarded the referral to the Office of Thrift Supervision (OTS), and the U.S. Department of Justice for further investigation.

The FDIC begins Criminal Probe of American Continental Corporation

Congress abolished the FSLIC and transferred its responsibilities to the Federal Deposit Insurance Corporation (FDIC). The FDIC hired Morrison & Hecker Law firm to investigate the regulators' allegations of criminal activity between American Continental and the $3.9 billion collapse of Lincoln Savings (Binstein and Bowden; 1993, p. 6). Michael Manning, an attorney for Morrison & Hecker, specialized in bank fraud, uncovered the biggest criminal bank fraud in U.S. history done by American Continental (Binstein and Bowden; 1993, p. 8). Manning uncovered evidence on insider deals, shredding of Lincoln's files, accounting gimmickry in Lincoln's books, and the looting of Lincoln Savings.

Manning filed a 168-page Racketeering Influenced and Corrupt Organization (RICO) complaint seeking the return of $1.25 billion from American Continental Corporation (Day; 1993, p. 343). RICO charged that American Continental had stolen $1.1 billion dollars of federally insured funds from Lincoln Savings through several fraudulent investments (Binstein and Bowden; 1993, p. 365).

American Continental's criminal activities included (1) expenditure over $10 million on a project in dying downtown Detroit to finance the Hotel Pontchartrain; (2) it recorded billions of dollars in risky investments that were false profits; (3) a transaction that involved a $30 million loan to a home-building company owned by R. A. Ober, Senator DeConcini's campaign manager in 1988; (4) Keating and American Continental's employees paid themselves $34 million in salaries, bonuses, and stock options; (5) Keating spent more than $35 million on the care of American Continental's pilots and aircraft; and (6) Keating owned residences worth more than $7 million and a retreat in the Bahamas (Binstein and Bowden; 1993, p. 366).

On August 9, 1989, the OTS closed Lincoln Savings. Kenneth Leventhal & Company's accountants analyzed 15 of Lincoln's real estate deals and concluded that they were fraudulent transactions using "accounting gimmickry" to produce spurious profits (Lowy; 1991, p. 150). These deals created $135 million in paper profits since American Continental acquired Lincoln Savings (Adams; 1990, p. 252). The report concluded:

> Seldom in our experience as accountants have we encountered a more egregious example of the misapplication of Generally Accepted Accounting Principles. This association was made to function as an engine designed to funnel insured deposits to American Continental in tax allocation payments and dividends. To do this, it had to generate reported earnings. It generated earnings by making loans or other transfers of cash or property to facilitate sham sales of land. It created profits by making loans. Many of the loans were bad. Lincoln Savings was manufacturing profits by giving its money away (Adams, 1990; Rom, 1996).

The OTS estimated it would cost American taxpayers at least $2.5 billion to liquidate Lincoln Savings, not counting the $400 million in assets that American Continental transferred the night before the federal regulators seized Lincoln Savings (Rosenblatt; 1992, p. A1). OTS ranked the scandal as the highest in the history of the FDIC (Adams; 1990, p. 253).

How did the *Lincoln Savings & Loan Scandal* come about? What were the acts of omission on the part of governmental agencies that helped make it possible? Was the lack of the Bank Board's effort to follow-up on Lincoln Savings' direct investments resulted in seriously inadequate enforcement in the industry? Why did the Bank Board under Ed Gray take no action in a reasonable time about Lincoln Savings' risky investments? Why did the Bank Board under Danny Wall fail to take action against Lincoln Savings? Finally, why did the regulators failed to seize Lincoln Savings from American Continental when it had strong evidences of criminal activities occurring at Lincoln Savings?

Omission by the Federal Government

Two federal agencies failed in several ways. First, the Bank Board was statutorily responsible for insuring the safe practice of services provided by federal and state-chartered S&Ls. The Bank Board under two chairmanships had known for some time about the regulatory violations at Lincoln Savings. Yet, both Bank Boards took no effective effort to remedy the situation except to shift the responsibility and delay the closing of Lincoln Savings. Second, the FHLB-SF regulators, who had the authority to seize Lincoln Savings, failed to take action. Instead, they made two recommendations to the Bank Board to allowed Lincoln Savings to remain open. Therefore, the regulators' recommendations allowed Lincoln Savings to remain in American Continental's possession to continue its criminal activity.

On June 22, 1987, the regulators' recommendations arrived on the desk of Shannon Fairbanks, Gray's chief of staff. The closing of Lincoln Savings was not high on Gray's "To Do" list (Adams; 1990, p. 248). He had good reason to let the issue ride. A provision of the Garn-St Germain Act that authorized the Bank Board to close state-chartered S&Ls had expired (Day; 1993, p. 265). The only available sanction was to rescind Lincoln's deposit insurance. However, Gray's staff warned him that it might appear that he was trying to get Keating in a last gasp act of revenge. They told him that this might somehow give credence to Keating's allegations that he had a vendetta against Keating (Adams; 1990, p. 248).

Furthermore, board member Lawrence White made it very clear to Gray. "He did not want to take up major matters until after the new board under Melvin Danny Wall took office" (Adams; 1990, p. 249). Therefore, Gray failed to take any action against Lincoln Savings. He ended his four-year term as Chairperson of the Bank Board and left the regulators' recommendations to his successor Melvin Danny Wall.

On July 1, 1987, Danny Wall became chairperson of the Federal Home Loan Bank Board. Wall was no stranger to politics or the Senate, where he was the staff director of the Senate Banking Committee. He spent eleven years as an aide to Senator Garn (Borger and Hedges; 1989, p. 21). Also, Wall helped shape much of the Garn-St. Germain Act when he was on the Banking Committee's staff. Under the new Bank Board, Wall's immediate job was to close Lincoln Savings (Adams; 1990, p. 249).

On August 10, 1987, Wall received the recommendation to close Lincoln Savings (Lowy; 1991, p. 220). Wall and his aides sifted through material that contained information that would have been enough for the Bank Board to take enforcement action against Lincoln Savings.

However, they overlooked the evidence needed to close Lincoln Savings. The regulators' findings did not convince Wall to close Lincoln Savings. Instead, Wall and his top aide enforcement, Darrel Dochow, decided that because the battle between Gray and Keating evolved into a personal fight and the facts were difficult to sort out. Both agreed that the Bank Board did not have a solid case against Lincoln Savings (Day; 1993, p. 338). Wall decided that he wanted to mend relations with Keating. Therefore, Dochow rescinded the criminal referral mentioned by the regulators, and they wanted to meet with Keating (Adams; 1990, p. 250).

On September 2, 1987, Wall and Dochow met with Keating at the Bank Board's headquarters to defuse the heated controversy (Seidman; 1993, p. 188). Keating complained that he was "frustrated by this exam that was ongoing" (Borger and Hedges; 1989, p. 24). "The zealots at the Federal Home Loan Bank in San Francisco were out to get him because he had fought Gray's direct investment regulation" (Lowy; 1991, p. 220).

In November 1987, the Bank Board's Office of Regulatory Activities informed Wall that Lincoln Savings, "Currently presents an excessive risk to the industry and is operating in an unsafe and unsound manner" (Day; 1993, p. 342). Wall assigned Dochow to oversee a complete reevaluation and deferred Lincoln's closing (Seidman; 1993, p. 188). Dochow asked two top staff members to do the review, Assistant Director for Regional Operations, Al Smuzynski and Kevin O'Connell (Day; 1993, p. 339). Thus, Smuzynski conducted the review.

In December 1987, Smuzynski sent a memo to Dochow stating that the regulators had been right in their findings. "I recommend that the

Bank Board proceed with a consent cease and desist order, which addressed the unsafe and unsound practices at Lincoln Savings and take other measures to restructure the organization of the thrift" (Day; 1993, p. 339). Dochow did not accept Smuzynski's recommendation. He decided that regulators might have been correct in their fact-finding, but they were not necessarily correct concluding that Lincoln Savings should be closed. In addition, Dochow did not agree that a consent cease and desist order was necessary. He felt that "Lincoln's future need not be as bleak or hopeless as viewed by the San Francisco Bank" (Day; 1993, p. 339). He concurred with Wall's desire to seek a "peaceful resolution" to the Lincoln Savings' dispute (Day; 1993, p. 339).

The second agency that could have acted to close Lincoln Savings, but did not act, was the Enforcement Review Committee (the Committee). On December 23, 1987, Danny Wall announced the creation of the "Enforcement Review Committee" to evaluate all recommendations and enforcement action against all federally and state chartered S&Ls such as Lincoln Savings' case (Mayer; 1993, p. 21). He stated, "The creation of this committee is another significant step taken by the Bank Board. It emphasizes the importance of prompt and effective enforcement actions against institutions that are unwilling or unable to comply with statutory and regulatory requirements" (Day; 1993, p. 339). However, the committee consisted of people close to Wall were Dochow, Top aid; Jordan Luke, the Bank Board Chief Counsel; George Barclay, President of the Federal Home Loan Bank of Dallas; Rosemary Stewart, Director of Enforcement; and Karl Hoyle, Communications Director, who functioned as a political adviser to Wall.

The Committee suggested that the Bank Board transfer the oversight of Lincoln Savings from the San Francisco field office to the Federal Home Loan Bank of Seattle. However, Officials in Seattle opposed the idea. After reviewing Lincoln Savings' record, Seattle officials recognized that such a transfer would be unprecedented to allow S&Ls to shop for the regulator they liked best (Day; 1993, p. 339).

Meanwhile, the Committee held 23 hours of hearings to review the evidence against Lincoln Savings from February 1988 to May 1988 (Mayer; 1993, p. 213). The Bank Board and the Committee met at the Bank Board headquarters for a meeting. During the meeting, most of the discussion centered on whether or not Lincoln Savings should have the right to change supervisors.

In a curious report, the Committee deplored the "seriously adversarial relationship" between Lincoln Savings and the FHLB-SF regulators (Adams; 1990, p. 250). Dochow presented the Committee's conclusions to the Bank Board. Dochow wrote: "First, Lincoln Savings is not insolvent now and will not necessarily be insolvent in the future. Second, there are many significant disagreements among experienced, competent, and thoughtful individuals about the soundness and risks involved in Lincoln's operations. Third, Lincoln Savings and the Agency Functions Group at the San Francisco Federal Home Loan Bank have a seriously adversarial relationship that prevents normal supervisory communications. Finally, there have been repeated leaks of confidential Bank Board's information that have damaged Lincoln's reputation"

(Mayer; 1993, p. 211).

Members of the Committee agreed to transfer Lincoln Savings' regulatory responsibilities to the Bank Board in Washington, D.C. However, board member White, the only Democrat, expressed his concern about the appearance of such a transfer before the Bank Board cast their votes. The notion that an S&L could "shop for a regulator is a very, very serious problem" (Day; 1993, p. 340). Yet, Wall and new member Roger Martin remained unconvinced and cast their votes. The Bank Board voted 2-1 to take supervision of Lincoln Savings away from the San Francisco Federal Home Loan Bank and transfer it to the Bank Board's headquarters (Pepinsky and Jesilow; 1991, p. 73). Thus, Wall made the unprecedented decision to remove the regulatory supervision of Lincoln Savings from San Francisco to Washington, D.C. (Pizzo, Fricker, and Muolo; 1989, p. 295).

The decision to transfer the supervision of Lincoln Savings humiliated the regulators in San Francisco. Cirona complained, "Wall's action crippled the independence of his examination staff and undercut every regulator in the country" (Pizzo, Fricker, and Muolo; 1989, p. 295). "It undermines the integrity and the perception of the integrity of the supervisory process" (Day; 1993, p. 341). "It will encourage [banks and S&Ls] to say, 'Let's make big contributions to politicians and maybe if we do, we can buy our way out of the grasp of a tough regulator'" (Day; 1993, p. 341).

Meanwhile, Wall and Enforcement Director Rosemary Stewart negotiated a "Memorandum of Understanding" (MOU). This MOU terminated (1) Lincoln Savings' action against the Bank Board; (2) removed Lincoln Savings from the San Francisco's jurisdiction; (3) provided a new examination by Washington, D.C. Bank Board personnel; (5) required American Continental to put $10 million of new capital into Lincoln Savings; (6) required Lincoln Savings to improve its underwriting and record keeping; (7) restricted several categories of investments; and (8) the Bank Board would not seek a criminal prosecution against American Continental (Lowy; 1991, p. 221).

The MOU amounted to the Bank Board giving Lincoln's operation a clean bill of health during the new examination. It was a document that many federal officials thought was so lenient that the San Francisco regulators dubbed it "Rosemary's baby" (Borger and Hedges, 1989; Day, 1993). Stewart defended the MOU, arguing that it "in no way bound the agency or restricted us for taking action" (Borger and Hedges; 1989, p. 245).

In addition, Wall assembled a new team of examiners from the Home Loan Banks' staffs around the country and placed them under the direct control of Dochow. Dochow forbid examiners to read Lincoln's original documents. He supplied them with copies (Davis; 1997, p. 33). The examiners finished its examination of Lincoln Savings. The examiners' audit uncovered evidence of assets moved from Lincoln Savings to American Continental. They accused American Continental of "cooking the books" to make itself and Lincoln Savings appeared healthy (Day; 1993, p. 341).

Furthermore, examiners contended that American Continental made deals with insiders and affiliated companies that cost Lincoln Savings more than $100 million between 1986 and 1988 (Pizzo, Fricker, and Muolo; 1989, p. 295). The deals allowed subsidiaries to advance cash to American Continental to cover tax liabilities. The plan was one more device to benefit American Continental at the expense of Lincoln Savings" (Long; 1993, p. 39). Therefore, examiners demanded that American Continental relinquish control of Lincoln Savings immediately (Rom; 1996, P. 243).

Although the Keating Five did not have regulatory control over Lincoln Savings, their political influence allowed Lincoln Savings to remain in American Continental's possession. American Continental's massive political contributions ensured that the Keating Five would handle Keating's problems at the highest levels. When a reporter asked whether his large political campaign contributions assured him influence over the Keating Five, Keating replied, "I want to say in the most forceful way I can. I certainly hope so" (Adams, 1990; day, 1993; Rom, 1996).

Senator DeConcini admitted as much. He stated, he knew going to bat for a big donor might raise questions. "I knew I had to have some justification to satisfy myself precisely because this guy is a big contributor. In retrospect, I made a mistake" (Borger and Hedges; 1989, p. 24). However, the Keating Five maintain it was another version of constituent service. They claimed that Keating was a constituent (Smart; 1989, p. 60). Yet, the intervention of the Keating Five protracted the regulatory examination process and afforded American continental additional time in which to exacerbate its criminal fraud.

Judge Stanley Sporkin took the opportunity to speak out against the role of private-sector professionals during a $1.1 billion civil lawsuit trial filed by the OTS. He stated, "What has emerged is not a pretty picture. It is abundantly clear that American Continental's officials abused their positions with respect to Lincoln Savings. Bluntly speaking, their actions amounted to looting Lincoln Savings. Indeed, it was done with a great deal of sophistication. The transactions were all made to have an aura of legality about them" (Rom; 1996, p. 244). He described Keating's treatment of Lincoln Savings as an analogous to "an adult taking candy from a helpless child" (Binstein and Bowden; 1993, p. 383).

Further, Judge Sporkin noted that Lincoln Savings symbolized the breakdown of private-sector safeguards who failed to detect the apparently wide spread abuses that led to the scandal. "What is difficult to understand is that with all the professional talent involved, legal profession and accounting profession, why at least one professional would not have blown the whistle to stop the overreaching that took place in this case"(Binstein and Bowden; 1993, p. 383)? "Why didn't any of them speak up or disassociate themselves from these transactions? Where were these professionals when these clearly improper transactions were being consummated" (Day; 1993, p. 350)? Specifically, Danny Wall's unusual decision to switch regulation of Lincoln Savings from San Francisco to Washington, D.C. as "inexplicable and clearly inappropriate" (Day; 1993, p. 349).

Representative Henry Gonzalez, Chairperson of House Banking Committee, commented when the government seized Lincoln Savings, "The Lincoln case is exhibit number one in the failures and mismanagement of the Bank Board under Danny Wall. The Bank Board had known from the day that Danny Wall took office that Lincoln Savings was sick. It took no action. In fact, its only action was to block regulatory moves by the San Francisco Federal Home Loan Bank. It is one of the saddest cases in a long, long list of regulatory disasters. Danny Wall's political decision and outright sabotage of regulatory actions will cost American taxpayers approximately $3 billion" (Calavita, Pontell, and Tillman; 1997, p. 27).

The failure of California State Government

The operations of the state government agency played its role in contributing to the scandal. California State Regulatory Commission is responsible for all state-chartered S&Ls. California State regulators were responsible for the regulatory examination and supervision of Lincoln Savings. The state regulators must comply with all federal regulations. However, California State Regulator Lawrence Taggart did not comply with federal regulations. He approved the change of control for Lincoln Savings to American Continental without checking the SEC before approving the sell of Lincoln Savings. If he would have checked with the SEC, he should have denied the sell because of Keating's 1979 run-in with the SEC (Jeffrey; 1990, p. 18). This factor suggests that the California State Regulatory Commission did not take the issue of Keating's SEC record seriously enough to insure that it would protect Lincoln Savings and Lincoln's members from criminals like Keating.

In the end, the bankruptcy protection did not protect American

Continental and Keating from criminal indictments related to the *Lincoln Savings & Loan Scandal.* Keating came under scrutiny by state and federal prosecutors as part of the investigation into the Lincoln debacle. State and federal prosecutors had acknowledged that American Continental had defrauded investors and committed a host of securities fraud since the take over of Lincoln Savings in 1984.

California State Authorities Indicate Charles H. Keating Jr. for Fraud

On September 19, 1990, California authorities arrested Charles H. Keating Jr. and booked him into the Los Angeles Country Jail. A California Grand Jury indicted him on forty-two counts of criminal fraud (Farnham, 1990; Greenwald, 1990). State authorities accused Keating of defrauding Lincoln Savings' members out of $250 million of worthless junk bonds (Day; 1993, p. 392).

The lead headline of the *Los Angeles Times* announced in bold print, **"KEATING INDICTED FOR FRAUD, JAILED"** (Granelli; 1990, p. A1). Keating's police "mug shot" dressed in jailhouse blue appeared on the front pages of newspapers and news broadcasts across the country. "Keating trades his business suit for prison blues" (Stolberg; 1990, p. A1). He could face up to 10 years in prison and a $250,000 fine if he found guilty (Kerwin; 1991, p. 36).

Los Angeles District Attorney Ira Reiner stated, "Keating's photo should be hung in every boardroom in America to warn executives not to be like him (Binstein and Bowden, 1993; day, 1993). It was quite a turnabout for a man who at the height of his power in the roaring eighties, commanded an estimated $100 million corporation fortune, controlled $1 billion in financial assets, and counted five U.S. Senators among his powerful buddies (Magnuson; 1990, p. 43).

In September 1991, Keating's trial started in Los Angeles Superior Court for criminal fraud. The jury heard two months of testimony that argued on a narrow part of the complex charges against Keating in connection with the junk bond sales. The trial focused on whether Keating and American Continental Corporation defrauded 18 of the 23,000 investors. Los Angeles District Attorney William Hodgman [prosecutor in the O.J. Simpson's murder trial] pinned the state's case on proving that Keating failed to disclose to investors that the federal government did not insure the junk bonds (Kerwin; 1991, p. 36).

District Attorney Hodgman contended that the mosaic pieced together from the evidence of more than 50 witnesses who testified that Keating was in charge at Lincoln Savings for the junk bond sale program that beguiled naïve investors. Former Lincoln Savings' employees testified of trips to Phoenix, where Keating exhorted them to sell more junk bonds (Kerwin; 1991, p. 36). Several senior citizens investors testified that representatives at Lincoln's branch offices persuaded them to cash out their federally insured certificates of deposit and buy American Continental's junk bonds. Yet, the strongest prosecution testimony came from former Lincoln Savings President Ray C. Fidel, who pleaded guilty to six counts of fraud. Fidel testified, "He told Keating that federal regulators insisted on moving the bond sales out of Lincoln branches." Keating replied, "Can't we cheat" (Kerwin; 1991, p. 36)?

Keating's defense lawyer, Stephen C. Neal, believed that state prosecutors could never link Keating with any false presentation of junk bonds to 18 investors. Keating's defense was that he was not directly involved in the bond sales, and he relied on advice from lawyers and accountants about the bonds. Neal used his cross-examination to elicit testimony favorable to Keating from some prosecution witnesses. However, Neal surprised courtroom observers by resting his case without calling any defense witnesses. He said, "The prosecution hasn't come close to proving that Keating knowingly and intentionally defrauded 18 investors named in the case" (Kerwin; 1991, p. 36).

On December 4, 1991, Los Angeles Superior Court jury convicted Keating on 17 of 18 counts of securities fraud for aiding and abetting in the fraudulent sale of American Continental's junk bonds (Granelli and Bates, 1991; Furlong, 1991). Keating faced sentencing before Judge Lance Ito. He addressed the bench, "I'm not a swindler as charged and convicted, but a man who made quality investments and never bilked the bondholders who loaned me a quarter of a billion dollars, money that is all gone as I speak this day. Some day I hope, I will be able to tell that story in full" (Binstein and Bowden; 1993, p. 33).

However, Keating's speech did not sway Judge Ito. Judge Ito noted that American Continental's representatives wore t-shirts that read, "Bond for Glory." He pointed out that Songwriter Woody Guthrie thought that more money was stolen with a fountain pen than with a sword (Celano; 1992, p. 33). Thus, Judge Ito sentenced Keating to 10 years in prison for his role in the sale of junk bonds to Lincoln's investors (Coleman; 1994, p. 30). Furthermore, Judge Ito ordered Keating to pay a fine of $250,000 (Binstein and Bowden; 1993, p. 404). However, Keating's problems did not stop there. He faced a federal grand-jury probe of securities violations.

Federal Authorities Indicate Charles H. Keating Jr. for Fraud

In December 1991, the federal authority indicted Keating on 73 counts of securities fraud (Collingwood, 1991; Kerwin, 1991; Sandler, 1991). The indictment alleged that American Continental and Arthur Andersen employees (1) gave false financial information to obtain a loan; (2) knowingly kept false records and books; (3) knowingly provided false information to regulators; and (4) breached the fiduciary duty to the institution (Calavita, Pontell, and Tillman; 1997, p. 20).

In October 1992, Keating's federal trial began in Los Angeles, California. Former American Continental President, Judy Wischer, became a key witness for the government. She supplied one key element in the case. She testified under oath, "Lincoln's employees motivation for preparing the summaries in March 1986 was to get information in the files that clarified and improved the files because without the summaries, something was missing" (Mayer; 1993, p. 192). She affirmed, "Examiners' imminent arrival at Lincoln Savings was an important factor in Keating's decision to prepare the summaries" (Mayer; 1993, p. 192).

On January 6, 1993, the federal grand jury delivered its verdict against Keating. The jury convicted Keating on 73 counts of racketeering, fraud, and conspiracy (Day; 1993, p. 392). Thus, Judge Mariana Pfaelzer sentenced Keating to 12 years in prison, fined him $17 million, and ordered him to forfeited $265 million in assets (Binstein and Bowden, 1993; Celano, 1993; Day, 1993). Keating's sentences were among the stiffest for crimes related to fraudulent activity at S&Ls (Rhoads; 1995, p. 8).

However, on October 3, 1996, U.S. District Judge Pfaelzer released Keating from prison on bail after serving 4 1/2 years of a 12-year sentence on his state convictions and about 7 years left on his federal sentence (Davis; 1997, p. 28). Keating's lawyers obtained statements from several jurors and alternates after Keating's federal convictions. The statements indicated that at least some jurors on the panel knew about Keating's state conviction. Judge Pfaelzer had ruled before the trial that evidence of Keating's state convictions could not be admissible (Reckard, 1996; Zagorin, 1997). She believed that jurors would be more inclined to convict Keating if they knew that a state jury had found him guilty on similar allegations (Davis; 1997, p. 28).

On December 3, 1996, Judge Pfaelzer overturned Keating's 1993-federal conviction for fraud (Greenwald; 1996, p. 56). She ruled that the jury improperly concealed knowledge of his 1991-California state conviction on similar charges (Morris, 1996; Celano, Sanders, and Liaison, 1996). Judge Pfaelzer stated, "Jurors had discussed the state conviction in the jury room. Therefore, the information denied Keating a fair trial" (White; 1999, p. 1). The federal government appealed Judge Pfaelzer's ruling.

On June 9, 1998, the Ninth U.S. Circuit Court of Appeals upheld a 1996 decision by U.S. District Judge Pfaelzer to overturn Charles Keating's federal convictions. The Court's 3-0 ruling upheld that Keating was entitled to a new trial on federal securities charges because jurors improperly learned of state convictions on similar charges. Assistant U.S. Attorney Bard Sonnenberg told Judge Pfaelzer that the government intended to retry Keating again on charges that would re-examine the *Lincoln Savings & Loan Scandal.*

Meanwhile, Neal said that he would appeal to authorities for a "sense of fairness and sense of order" to let Keating remain free until his appeal is resolved. "The man has spent almost five years in prison on convictions that have major flaws. He is 74 years old. He's never going to run anywhere" (Davis; 1997, p. 30). Thus, Keating is confident that the court will exonerate him from any remaining legal issues (Davis; 1997, p. 30). As of January 2002, federal authorities have not retried Keating. The likelihood of any criminal retrial arising from the *Lincoln Savings & Loan Scandal* has diminished because the statute of limitations had expired (Rhoads; 1995, p. 8).

CHAPTER 5

THEORETICAL INTERPRETATION

One form of state-corporate crime focuses on the direct role of the state in initiating a cooperative activity involving both government and a private business that can lead to a deviant outcome. The second form of state-corporate crime suggests a different kind of relationship. This relationship is where government omissions permit corporations to pursue illegal and potentially harmful courses of action. It is where the state facilitates the criminal behavior of the corporation. It is one of the least recognizable forms of state involvement in crime. Clearly, the *Lincoln Savings & Loan Scandal* was a case of *state facilitated state-corporate crime*, which identified specific actions by governmental agencies that led to identifiable social harms.

The data show that state-corporate crimes like the Lincoln Savings & Loan case are a serious social problem that penetrates all aspects of life and undermines relations of trust and principles on the foundation of American institutions. The physical and economic toll for individuals and for society as a whole from these crime are staggering. Given the extent of state-corporate crime, it is crucial to understand its causes. What motivates the corporate criminal? What conditions and circumstance are associated with state-corporate misconduct? This chapter will review the theories of organizational crime.

Theories of Organizational Crime

Social-Psychological Explanations

Social-psychological theories state that crime lies within the individual. They view criminals, especially street criminals, as psychiatrically disordered or psychopathic. Corporate criminals, rather than being seen as deranged, are suspected of being egocentric, morally flexible, overly ambitious, and prone to risks (Simpson; 1993, p. 243). However, criminologists should not dismiss the social-psychological perspective because it is possible that personality characteristics lead to crime (Simpson, 1993). For instance, a manager who is overly concerned with pleasing others might be vulnerable to peer or supervisor pressure to violate the law.

The social-psychological level of analysis examines individuals within a group context. This micro approach is Sutherland's differential association theory. Differential association theory was one of the first theories applied to white-collar crime, which addressed the individual level of action. Differential association meant to explain both the process by which a given person learns to engage in crime and the content of what is learned.

Differential association holds that individuals learn criminal behavior like any other behavior, and this process of learning takes places primarily in intimate, personal groups and in isolation from those who define such behavior unfavorably (Sutherland, 1940; 1949). The more an individual associates with those with favorable attitudes toward crime, the more likely an individual will engage in behavior if the weight of the favorable definitions exceeds the weight of the unfavorable definitions. Applying these principles to white-collar crime, Sutherland vigorously rejected any notion that immorality, physical make-up, or psychological characteristics of the criminals caused white-collar crime. Individuals become white-collar criminals because they learn to act that way, often from their associates on the job (Sutherland, 1949).

However, social-psychological theories do not provide a clear picture of why organizations violate the law. Their failure to incorporate the organizational and structural levels of analysis is a major weakness. Its present offenders as a few bad apples and ignores the nature of organizations as social actors. Theories that focus only on social-psychological variables cannot adequately explain why organizations as social actors violate the law. Why do some organizations violate the law while other organizations do not? Why are some organizations criminogenic at one time and not criminogenic at others? The organization is the key to understanding how criminal motivations, pressure to commit crimes, and criminal opportunities emerge. Thus, macro sociological rather than individual levels of explanation is necessary to explain organizational crimes.

Organizational Explanations

Organizational theorists argue that the organization itself should be central to the analysis of organizational crime (Clinard and Yeager, 1980; Ermann and Lundman, 1978; Finney and Lesieur, 1982; Gross, 1978; 1980; Kramer, 1982; Scrager and Short, 1978; Vaughan, 1982; 1983). Among the features of organizations that are criminogenic, both culture and structure warrant discussion. *Organizational culture* refers to the shared language, symbols, rituals, and belief of an organization and its members. *Organizational structure* refers to the design of a company, what form it assumes, its authority structures, its lines of communication, etc (Simpson; 1993, p. 244). Corporations are organizations that seek two primary goals: (1) profit and (2) expansion of market share. These goals permeate the various subunits of the organization (such as sales and marketing, finance, and productions), and flow across organizational positions. What people do in corporations and how they are evaluated reflect these organizational goals? Thus, individuals come to identify with the corporation and its goals.

The focus on goals is the central characteristic of organizations and therefore, of organizational crime; organizations are evaluated in terms of their successes or failures in the attainment of goals. For an organization to be successful, each organization must have an internal social structure designed to achieve its goals, consisting of internal processes and hierarchical series of positions or status relationships. Organizations vary in the ways in which their social structures systematically and continuously generate unlawful organizational behavior. Of considerable importance is the fact that some internal social structures and processes "often tend to produce tensions for organizations to obtain goal unlawfully" (Vaughan; 1982, 1378).

Furthermore, organizations could be criminogenic either due to performance emphasis on goals (Gross, 1978; Finney and Lesieur, 1982; Kramer, 1982) or because of defective standard operating procedures (Hopkins, 1978). In some corporations, illegality becomes standard operating procedure because it is ingrained in the corporation's structure.

In other words, organizations resort to deviant norms when legitimate means or goals are unobtainable.

Organizations often find themselves in hostile or difficult environments, surrounded by fierce competitors, or constrained by regulations, which interfere with their performances. Yet, pressures remain from executives who seek to advance their careers by successful operation of organizations. The stakes are very high and executives who run the organizations will experience almost irresistible pressures to do every thing possible to keep the organization moving toward attaining many goals. If "every thing possible" occasionally means breaking the law, the likelihood of doing so increases (Gross, 1978).

Organizational theorists argue that "there is built in to the very structure of organizations an inherent inducement for the organization itself to engage in crime" (Gross; 1978, p. 56). This organizational approach on corporate crime merged with a traditional criminological theory, Merton's theory of anomie (Passas, 1990). Organizations that are strongly goal oriented and concerned with performance might fine legitimate means to achieve goals unavailable or blocked in some way may induce strain and compel organizations to "innovate" and use illegitimate means to achieve their goals. "Barriers to the attainment of desired performance might generate such severe strain that agents resort to illegal solutions" (Finney and Lesieur; 1982, p. 270).

The anomie's tradition that focuses on the organizational level of analysis has been the most widely used theoretical perspective in the area of organizational crime (Passas, 1990). This perspective will be central to the integrated theoretical approach present in this chapter.

In addition to performance pressure and strain, organizational crime also seems to depend on two other factors. First, pursuing goals through illegitimate means depends on the availability of those illegal means. Organizational crime is more likely to occur when illegitimate opportunities for achieving the organization's goals are available to organizational actors (Braithwaite, 1989). Second, the social control environment also plays a role in fostering organizational crime. "Whether or not a strong performance orientation and operating problems lead to crime depends also on the operationally of various social controls" (Finney and Lesieur; 1982, p. 275).

While the organizational culture defines the parameters of criminal conduct, the organizational structure provides criminal opportunities. Corporate crime is associated with factor such as organizational size, diversification, autonomy, specialization, level of profitability, and growth. Because of their great business volume, large organizations provide more opportunities to violate the law. High degrees of autonomy and diversification isolate individual decision markers, reducing their visibility and magnifying problems of internal control. Illegal acts are easier to carry out and hide under these conditions. Loss of profits and market share can put pressure on organizations to do something to reverse the trend and that may turn out to be illegal.

The Structural Level Explanations: Theories of Political Economy

The third perspective on organizational crime operates on the structural or institutional level of analysis. This level deals with the larger social structure and the major social institutions of society, in particular, political and economic institutions and the interrelationship between them in an effort to explain organizational crime. This approach locates the criminogenic forces in the wider political economic structure of corporate capitalism (Barnett, 1981; Chambliss, 1988; Michalowski, 1985; Young, 1981).

The primary assumption of this perspective is that the structure of corporate capitalism, as an economic system, provides the major impetus toward organizational crime. Capitalism provides the major incentives for organizations to use illegitimate means to achieve profit or create the conditions under which capital accumulation might take place. As laws change, criminal opportunities also change. New laws produce a new set of offenders as it holds corporations to different standards. Corporations might deem old laws as irrelevant or political changes might determine which laws regulatory agencies enforce. This perspective extends the Mertionian strain model by considering how the mode of material production generates illegal activity.

Corporate crime will occur "when management chooses to pursue corporate goals through circumvention of markets constraints in a manner prohibited by the state" (Barnett; 1981, p. 5). A corporation will tend to circumvent those market constraints whose violation will yield the greatest expected net change in profit. Therefore, one can expect that corporation will be likely to choose to engage in crime when the expected costs of its illegal action are acceptably low relative to perceived gains other things being equal.

According to Michalowski, various criminal acts that criminologists refer to as white-collar crime can be brought together in a theoretically informed concept of "crimes of capital" (Michalowski, 1985). Crimes of capital are "socially injurious acts that arise from the ownership or management of capital or from the occupancy of positions of trust in institutions designed to facilitate the accumulation of capital" (Michalowski; 1985, p. 314). Corporate crime, state crime, organized crime, and occupational crime all arise from the particular forms of social relationship associated with the process of capital accumulation, concentration, and centralization (Michalowski, 1985).

The organizational perspective and the political economy perspective have many similarities. The major unit of analysis in both is the organization, whether corporation or the state. Both place great emphasis on the concept of organizational goals. Both analyze the problems organizations can encounter as they attempt to achieve goals through legitimate means. Both argue that organizations will turn to illegal means under circumstances of strain and both note the importance of social control mechanisms in controlling organizational crime. The critical difference is the way in which the political economy perspective stresses the shaping and constraining influence of the broader historical, institutional structure of society on organizational behavior (Kauzlarich and Kramer, 1998).

Theories of Organizational Crime Applied to Lincoln Savings & Loan Case

Organizational crime theorists have relied on three core concepts to explain crimes committed by corporations and governments. These core concepts are (1) motivation or organizational goals, (2) opportunity, and (3) social control (Braithwaite, 1992; Coleman, 1987; Kauzlarich and Kramer, 1998; Kramer and Michalowski, 1990, 1991; Vaughan, 1992). This framework indicates the key factors that will contribute to or restrain state-corporate crime at each intersection of a core concept and a level of analysis.

The significance of these core concepts to a structural level explanation of state-corporate crime is based on the proposition that criminal behavior at the organizational level results from a coincidence of pressure for goal attainment, availability and perceived attractiveness of illegitimate means, and an absence or weakness of social control mechanisms (Braithwaite, 1989; Kauzlarich and Kramer, 1998). This theoretical interpretation focuses on how structural relationships affect organizational practice and policy. This case study will discuss each core concepts separately the motivation and organizational goals, opportunity, and social control dimensions of the scandal in order to interpret the data from this case study.

Motivation and Organizational Goals

Most crimes involve both motivation and opportunity. All the motivation in the world to act in a particular way means little if the opportunity to carry out that action is not available. Individuals and organizations have varying kinds of goals and varying degrees of commitment to achieving those goals. Some theorists have argued that the greater the emphasis on goal attainment, the more likely the resulting behavior will be criminal. Given this assumption, one could expect that if an individual is highly goal oriented, works in an organization that evaluates performance strictly on goal attainment, in a society whose cultural and institutional structures emphasize achievement above all else, and then the chances for organizational misconduct are high (Kauzlarich and Kramer, 1998).

The *Lincoln Savings & Loan Scandal* supports the hypothesis that criminal or deviant behavior at the organizational level results from a coincidence of pressure for goal attainment, availability and perceived attractiveness of illegitimate means, and an absence of effective external and internal social control. The external political pressure on regulators and the internal organizational motivation of the Bank Board created a competitive environment to compete for funds, which placed enormous goal attainment pressure on Lincoln Savings. At one point, Lincoln Savings was unprofitable and close to insolvency. It experienced a high degree of pressure for capital accumulation to compete in the complex sophisticated financial market system of the 1980s. Lincoln Savings had to pay high interest rates to keep short-term funds in its institution in order to compete in the financial free market. Therefore, Lincoln Savings employed a number of questionable investments to maximize its profit.

However, when the Bank Board received information about American Continental's high-risk investments with Lincoln Savings' federally insured funds, the agency did not respond according to its organizational regulatory enforcement. The Bank Board made the decision to allow Lincoln Savings to remain in American Continental's control.

The other organization involved in the scandal was the Bank Board. The Bank Board was not directly a profit-seeking entity, but its function was to regulate and facilitate the accumulation of capital for Lincoln Savings. The Bank Board's refusal to enforce specific laws and regulations that could have prevented the debacle of Lincoln Savings demonstrates the injurious consequences that can result not only from pursuing profit, but also from state encouragement of capital accumulation.

A major goal of the United States has been to promote capital accumulation; and the state's regulatory function must then achieve two contradictory goals. First, it "must severe enough to maintain the legitimacy of the state." Second, it "must not be so severe as to diminish substantially the contribution of large corporations to growth in output and employment" (Barnett, 1981; Chambliss and Zatz, 1993).

Likewise, the government would not expect the Bank Board to compromise the contribution that Lincoln Savings made to local community and national economies. However, the difference between the Bank Board and other regulatory agencies was its dual function of regulating Lincoln Savings and promoting its economic success. The pursuit of profit was critical in the formulation of the Bank Board's organizational policy and practice. Thus, the actors, actions, omissions and social circumstance that surrounded Lincoln Savings' high-risk investments from the Garn-St. Germain Act, supervision, intervention, state and federal agencies, and the organizations of both the S&L industry and the U.S. political economy caused the *Lincoln & Savings Loan Scandal*.

Opportunity Structure

The second core concept directs attentions to the opportunity structure of means that organizations and their agents might use to achieve organizational goals. A proposition of organizational crime theory is that low levels of external social control provide opportunities for organizations to engage in crime. Not only a competitive environment shapes organizational behavior, but also "the regulatory environment, which is affected by the relationship between regulators and the organizations they regulated" (Vaughan, 1996, p. 458).

Economic deregulation and the contradictory role of the Bank Board as regulator and promoter of the S&L industry provided the larger background for Lincoln Savings' organizational genesis and persistence. This case study described the deficiencies and contradictions in the structural control of the S&L industry brought about by deregulation. This is related to the Bank Board's organizational disregard for the blatant violation of Lincoln Savings' fraudulent investments and practices. Instead of the Bank Board aggressively enforcing that Lincoln Savings make its investments in compliance with federal regulations, the Bank Board held Lincoln Savings as the "Jackpot" of economic deregulation (Waldman and Thomas; 1990, p. 27).

Given the authority and resources of the Bank Board, Lincoln Savings encountered both a favorable opportunity structure and a great deal of freedom from the Bank Board as it pursued its structural goals. With all the legitimate opportunities available, why then did Lincoln Savings use the illegitimate means described as crimes? As noted earlier, many organizations turn to illegal means to achieve organizational goals when legal means are blocked in some form. Lincoln Savings was not able to achieve its investments with federally insured funds because of the equity-rule. Therefore, Lincoln Savings found illegal ways to purse its goal.

On the structural level, it is clear that opportunities to commit fraud were readily available because of the Garn-St. Germain Act, the Nolan Act of 1983, the Keating Five, and how the Bank Board shielded Lincoln Savings from public scrutiny. Sufficient regulations were always in place for the investments of federally insured funds. However, the Bank Board held principal power and discretion over the FHLB-SF regulators' enforcement actions against Lincoln Savings.

On an organizational level of analysis, American Continental and Lincoln Savings were free to use the most effective methods to pursue their goals. However, the most effective means available threaten the S&L industry by selling uninsured junk bonds, land swapping, loan swapping, and fraudulent investments, which were illegal. Keating appeared to have had the opportunity as his organizations pursued the most effective means to complete American Continental and Lincoln Savings' role requirements. They were limited only by their questionable behavior from important control audiences.

Social Control

The third core concept is of social control mechanisms. Social forces exist at all three levels of analysis, exerting pressure on organizations and organizational actors and checking their efforts to select illegal means to goal attainment. At the structural level, criminal justice or other governmental regulatory bodies could impose various forms of legal sanctions. Public opinion could pressure offending organizations. Scrutiny from the mass media, social movement organizations, or citizen watchdog groups could exert social-control influence. At the organizational level, internal cultures of compliance might regulate the behavior of organizational actors. Finally, at the individual level, strong ethical standards might be an important defense against involvement in opportunities for organizational crime.

However, on the structural level, there was a lack of social control at Lincoln Savings. The Bank Board did not closely monitor social control at the organizational and institutional level of analysis. Lincoln Savings achieved its organizational goals without fear of publicity or legal challenges. The Bank Board's failure to enforce its "equity rule" for direct investments facilitated the fraudulent use of federally insured funds and the fraudulent sale of worthless junk bonds to 23,000 investors. Had the Bank Board enforced the laws and regulations at Lincoln Savings, the institution might have operated in a different manner.

Furthermore, there was a failure of social control because of the contradictory role of the Bank Board. The controversy that emerged in the wake of the scandal was the mismanagement of the Bank Board under Danny Wall. Serious deficiencies existed in the way the Bank Board responded to Lincoln Savings' criminal activities. Besides, the network of political influence, the structural flaw that sabotaged the Federal Home Loan Banking System consisted of conflicting responsibilities between the Bank Board and the San Francisco regulators. The Bank Board's responsibilities were to promote the welfare of the savings and loan industry, yet at the same time was the industry's regulator.

The FHLB-SF regulators had the responsibility for supervision and enforcement at Lincoln Savings, but had no legal authority to seize or close Lincoln Savings. The agency had to receive approval from the Bank Board before it could take any action against Lincoln Savings. This conflict allowed American Continental Corporation to remain in control of federally insured funds and continued its fraudulent activities. Furthermore, Wall transferred Lincoln Savings' oversight to a different jurisdiction to avoid closing the thrift. This unprecedented move set a new standard in the regulatory enforcement, and undermined the integrity and the perception of the supervisory process. Therefore, this contradictory role of government failed at the social control level.

CONCLUSION

In the *Lincoln Savings & Loan Scandal*, what emerged was a conservative small-town thrift that played a major role in the high-finance world of economic deregulation, which produced a "criminogenic environment" (Needleman and Needleman; 1979, p. 517). As this study revealed, Congress and the Bank Board intended to provide affordable housing in the country's financial system. Their overall goal was to prevent abuse and the perceived weakness of the financial system that led to the "Banking Holiday." However, economic deregulation combined with generous deposit insurance and the political intervention set the stage for the explosive growth at Lincoln Savings as well as the epidemic of financial fraud that accompanied Lincoln's growth in three ways.

First, economic deregulation exacerbated the Lincoln Savings' crisis and allowed it to become the most costly financial scandal in American history. American Continental saw a window of opportunity to restructure Lincoln Savings by its addiction to high-risk investments that had the potential to maximize profit at American Continental. Second, the evidence suggests that behind the policy shifts of the early 1980s, were members of Congress who selectively pushed for deregulation. The deposit insurance revealed the inadequacy of ideological motives for the policy shifts. The backroom decision surrounding these policy shifts had well documented connections between members of Congress and American Continental. This would suggest that private financial interest was at least as important as the ideology of economic deregulation. Finally, economic deregulation was the product of political decisions made by individuals with political and financial incentives. The "Keating Five" political intervention in shielding Lincoln Savings from regulatory scrutiny delayed the necessary supervisory action against Lincoln Savings. Their considerations favored Lincoln Savings and American Continental, but cost 23,000 investors and American taxpayers billions of dollars.

This case study indicates that many components of the system designed to protect the Lincoln Savings, from the Bank Board to the FHLB-SF regulators, had failed in order for the scandal to occur. The scandal is clear evidence that laws and regulations alone are not sufficient to prevent corporate fraud. They require political will for their effective enforcement. The scandal constitutes a clear instance of state-corporate crime because it was the absence of political will and omissions on the part of Bank Board that enabled the American Continental Corporation to continue violating federal laws and regulations at Lincoln Savings in its pursuit of private profits.

As with many cases in the Lincoln Savings imbroglio, there will probably never be definitive answers to all the questions concerning the criminal activities at Lincoln Savings, or the specific role-played by various actors. However, even though federal and state authorities eventually punished Keating for his role in the scandal, state-facilitated state-corporate crime allowed the ability to understand how the *Lincoln Savings and Loan Scandal* occurred.

State crime is one of the most important and complicated types of crime to study. State crime is important because it reminds us that the creator and enforcer of law can also be a criminal agent. Such crime may inflict a far greater amount of social injury than that caused by traditional street crime. The study of state crime is complicated because actors are generally powerful and privileged, and the authority of the state formally supports this power and privilege (Barak, 1993).

Many forms of state crime might be unrecognizable from what many might consider normative state policy. Legal responses to state crime are even less authoritative and problematic than the reaction to corporate crime. Reconstructing the events of a state crime can be difficult because the state has the power to conceal and classify documents that implicate wrongdoing. For example, Author Andersen Accounting firm shredding documents in the Enron Corporation scandal. Given these complexities and accompanying political and disciplinary problems, one should expect that the development of a solid criminology of state would be an arduous task (Barak, 1993; Tunnell, 1993).

This case study attempted to apply the most central theoretical concepts in the organizational crime literature to help explain the *Lincoln Savings & Loan Scandal.* The circumstances surrounding the scandal are complex, and a comprehensive theoretical explanation would be equally complicated. However, extant organizational crime theory renders the *Lincoln Savings & Loan Scandal* intelligible, although the extent to which these theories are generalize to other instances of state-corporate crime (state-initiated or state facilitated) must be addressed in future research.

In short, the research in this case study supports the multi-dimensional theoretical proposition that coincidence of a very strong level of motivation for the accumulation of capital by corporations and a severe lack of external control by governmental agency results in conditions conducive to harmful organizational practices in identifiable ways. State-corporate crimes result from an interaction of individual, motivation to commit crime, opportunity, and lack of social control. Further research can pinpoint how decision makers respond to pressures and how strains within and outside the organizations produce state-corporate crime.

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