

THE CONDITION AND REGULATION OF MADISON GUARANTY SAVINGS AND LOAN ASSOCIATION IN THE 1980S: A CASE STUDY OF REGULATORY FAILURE

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I. INTRODUCTION

This paper assesses the condition and regulation of Madison Guaranty Savings and Loan Association in the 1980s, its seizure in 1989, and its subsequent resolution. Madison was a small, state-chartered savings and loan in Arkansas that played an insignificant role in the savings and loan debacle by any economic measure. It became the focus of national attention, however, because its owners were friends, political supporters, and business partners of President and Mrs. Clinton. Madison became the focus of intense scrutiny after allegations were made that Madison received lax state regulatory treatment while President Clinton was governor of Arkansas, and that funds from Madison were inappropriately diverted to support the Clinton's political interests and what has become known as their Whitewater real estate investment.

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The paper provides a chronology of several important events in Madison's decline over its eleven-year existence, including who knew what and when among the relevant state and federal regulatory authorities.¹ It indicates who did what and when among the relevant regulatory authorities. It also discusses the proximate causes of the deterioration of Madison and its costly resolution. The goal of this assessment is to put Madison's seizure and resolution into a broader perspective indicative of the overall events of the time, and to indicate how Madison's experience is a case study of regulatory failure that in many respects permeated the entire savings and loan debacle.²

The paper is based on a review of Madison's financial statements filed with the Federal Home Loan Bank Board (FHLBB) and Office of Thrift Supervision (OTS) throughout the 1980s. For purposes of comparison, it is also based on a review of the financial statements filed by other Arkansas savings and loans—both federally and state chartered—that were seized at about the same time as Madison. All of these documents are publicly available.

In addition to these public documents, the paper is based on a review of documents that are generally confidential, specifically the Reports of Examination by the Federal Home Loan Banks of Dallas and Indianapolis and related federal and state supervisory documents concerning Madison in the 1980s. To our knowledge this is the only instance where a review of the examination reports and supervisory correspondence, including quotations from those documents, has been made public. The documents therefore provide substantial information about how an institution can get into trouble, the role played by state and federal regulators, and why the institution cost what it did to resolve.

II. A BRIEF HISTORY OF MADISON

Madison Guaranty Savings and Loan Association was a stockholder owned, state-chartered Arkansas savings and loan whose deposits were insured by the Federal Savings and Loan Insurance Corporation (FSLIC). Madison was in the Ninth District of the Federal Home Loan Bank System, which encompasses the five states of Arkansas, Louisiana, Mississippi, New Mexico, and Texas. The headquarters of the Ninth District was relocated from Little Rock to Dallas in September of 1983. The Arkansas Securities Commissioner, as head of the Arkansas Securities Department, was the state regulator of state-chartered savings and loans, including Madison.

Madison was originally chartered by the state of Arkansas as Woodruff County Savings and Loan Association in 1979. It became Madison after it was acquired in 1982 by James B. McDougal and Steven Smith. In October of 1983 there was a change in control of the institution with control going primarily to Mr. McDougal. Under a federal regulatory directive in 1986, Mr.

McDougal was removed from Madison's management, although he retained primary ownership of the institution. The president of Madison was also removed. Madison was seized by regulators in 1989. The Resolution Trust Corporation (RTC) currently estimates that the resolution cost of Madison is \$73 million.³ Madison was one of more than 1,100 savings and loans that failed from January 1981 through December 1991.

III. WHAT THE REGULATORS KNEW AND WHEN THEY KNEW IT BEFORE 1985

Madison's Deterioration and Growth in the Early 1980s

In financial statements filed with federal regulators, Madison—then formally Woodruff—reported losses for each year in 1979, 1980, and 1981. This poor performance mirrored industry-wide devastation when skyrocketing interest rates drove the cost of deposits to savings and loans well above the rates being earned on home mortgages. Between June of 1979 and December of 1981 Woodruff grew 46 percent from \$2.6 million to \$3.8 million in assets. Over the same period, its tangible capital or buffer of protection against losses to the FSLIC declined from 8.2 to 3.7 percent of assets. (Unless stated otherwise, financial data on Madison are from the financial reports regularly filed by Madison and other savings and loans with the FHLBB and OTS.)

According to a 1984 inter-office memorandum at the Federal Home Loan Bank of Dallas, an October 2, 1981 examination gave the institution a composite examination rating of 2C, on a scale of 1 to 5 with 1 being the highest rating. This performance rating is reported in Chart 1, a chronology of significant regulatory events in Madison's history. A rating of 2C suggests that there are no significant problems threatening the survival of the institution and no reason for significant regulatory concern.

All of the examinations depicted in Chart 1 were conducted by the FHLBB examiners in the relevant Federal Home Loan Bank. No examination was conducted by the Arkansas Securities Department either independently or jointly with federal examiners because, according to the OTS, the department had no savings and loan field examiners. Instead, federal examiners examined Madison for compliance with federal law and standards of safety and soundness. The Arkansas Securities Department reviewed independent audit reports, federal examination reports, and any other information available to it.

As the result of a special limited examination in April 20, 1982, Madison's composite rating fell within seven months to 4D, signifying problems that threatened the survival of the institution. The examiner noted that operating losses were understated and projected insolvency within seven months given

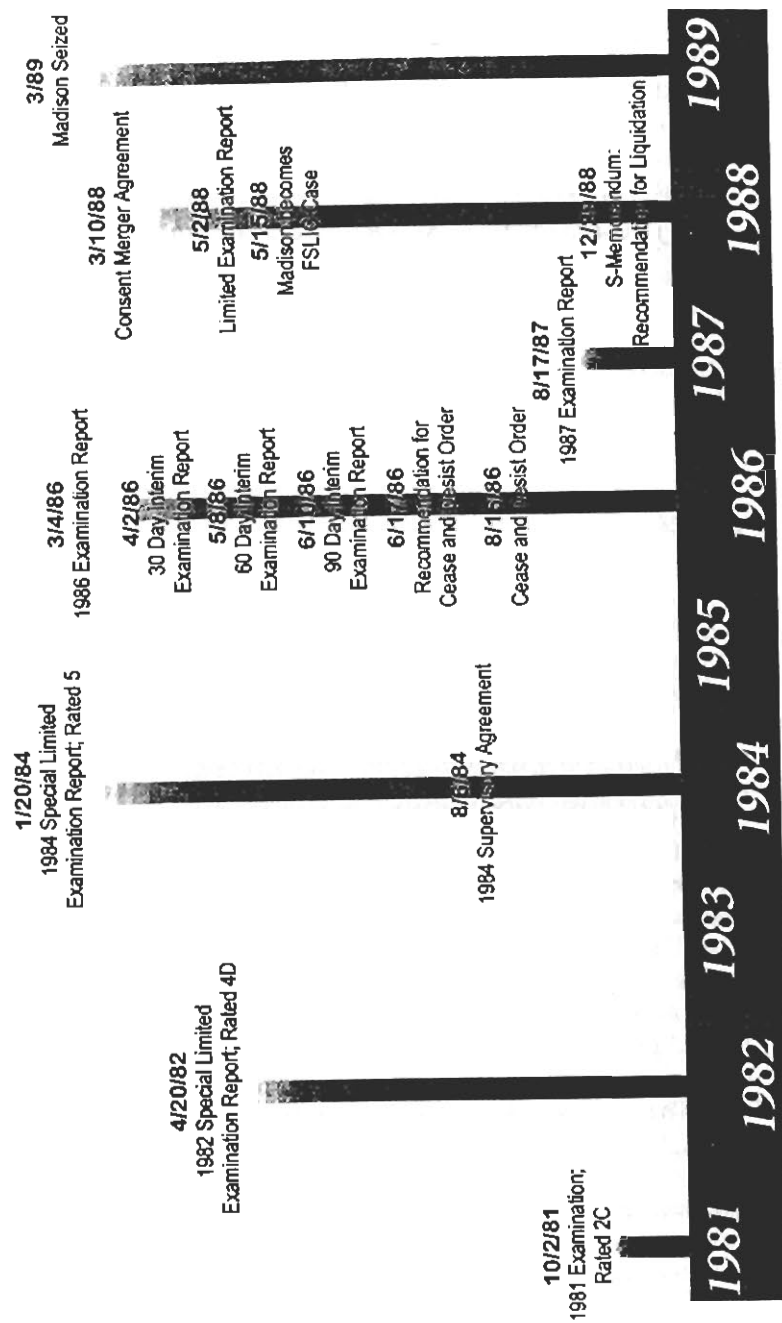


Chart 1. Madison Guaranty S&LA Regulatory Chronology

Source: Cited Documents, FHLBB

the magnitude of losses. In June of 1982, an infusion of \$100,000—although not all in cash—was recorded to replenish capital.

Madison then grew seven fold from year-end 1982 to year-end 1984, as Chart 2 shows. Its assets increased from \$6.7 million to \$48.6 million, which still left it far smaller than the average size savings and loan in the country—\$312 million. Over the same period and despite the earlier capital infusion, its reported capital-to-asset ratio was cut by two-thirds, to just 1 percent, as Chart 2 also shows. The rapid growth in size and deterioration in capital relative to assets were reported in financial statements filed with federal regulators and available to state regulators.

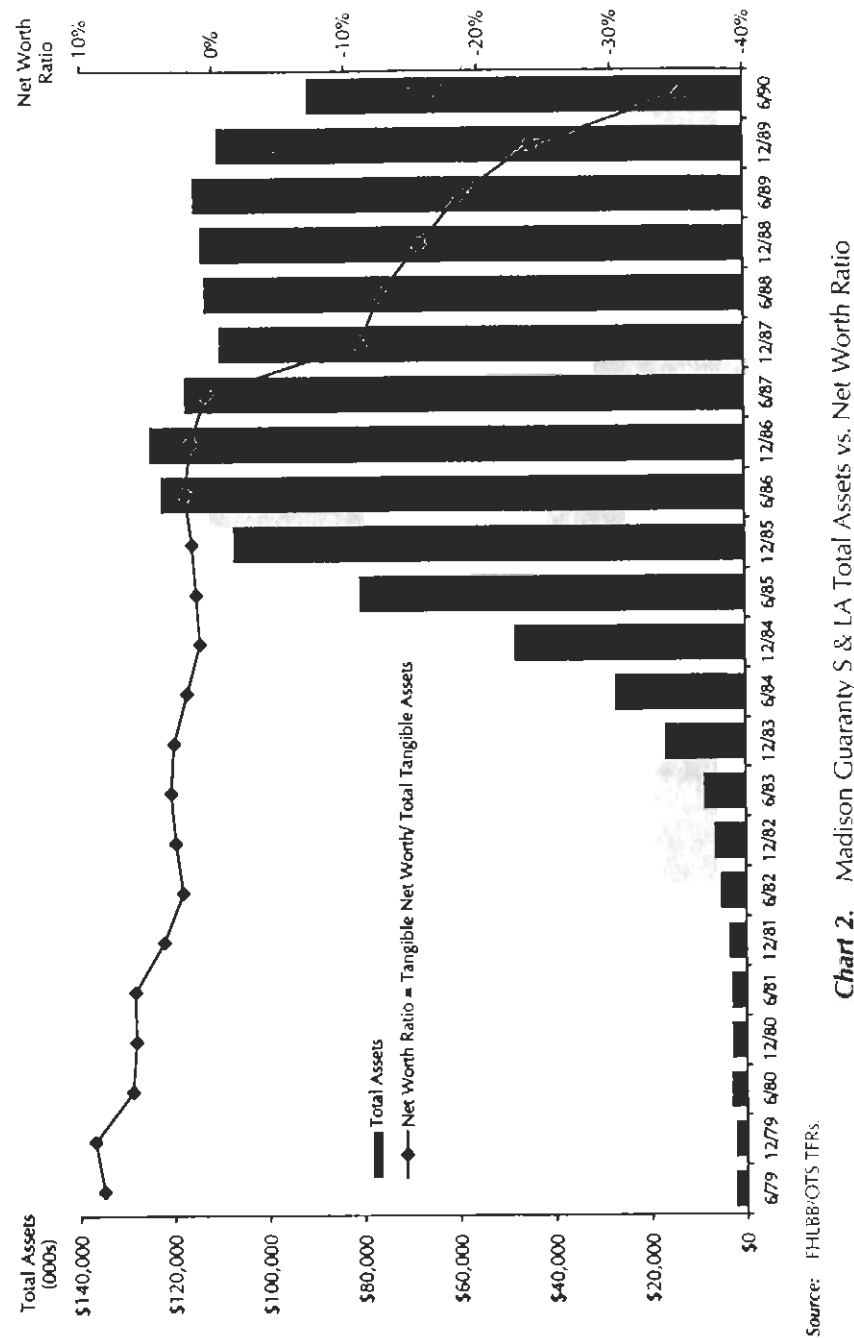
According to the OTS, the next special limited examination of January 20, 1984 resulted in a composite examination rating of 5, which continued to be Madison's rating until it was seized. According to the OTS, institutions rated 5 have "an extremely high immediate or near-term probability of failure...." Their "... weaknesses are such as to require urgent aid from the shareholders or other sources (such as merger partners or acquirers). Such institutions require immediate corrective action and constant supervisory attention...."

The 1984 examination noted the institution's high growth rate. At the same time, a review of mortgage loans and appraisal reports were considered "... indicative of unsafe and unsound lending practices in addition to numerous regulatory violations...." The examination also found that "A material decline will result in the net worth reported at December 31, 1983, when adjustments to correct profits recognized on the sale of real estate owned are made on the service corporation books ... the net effect will be that net worth will be eliminated...."

The supervisory agent subsequently required that only a portion of the profits identified by the examination had to be eliminated, thereby lowering the level of capital but not causing Madison to report insolvency. After the adjustment required by the supervisory agent, Madison's capital fell from an initially reported 3 percent to 1.3 percent at year-end 1983 and then to 1 percent at year-end 1984. The examination also concluded that the institution's "... operations and activities warrant close supervisory attention." The reason was in part that "The chief executive officer has ... no previous experience as a managing officer of either a banking or savings and loan institution...."

On August 6, 1984, FSLIC executed a Supervisory Agreement with Madison. A Supervisory Agreement is an enforcement action taken when, in the opinion of FSLIC, serious problems have persisted, generally for a significant time, without adequate response from the institution. Such an agreement specifies the problems that exist and stipulates what the institution needs to do to remedy them. Once a Supervisory Agreement is executed, failure to abide by it is considered a serious matter.

The Supervisory Agreement that was executed stated that Madison "may have" failed to comply with its minimum capital requirement and noted several



other regulatory violations that constituted unsafe and unsound practices.⁴ It stipulated that Madison would comply with its minimum capital requirement and stipulated what would be required to correct the other regulatory deficiencies. In exchange for entering into the agreement, the FSLIC stipulated to Madison that it was willing "... to forbear from the initiation of possible enforcement proceedings ... so long as Madison is in compliance with the provisions of this Agreement"

In 1984 there were a total of 116 Supervisory Agreements nationwide even though 695 institutions with \$336 billion in assets were reporting tangible insolvency. The total number of other enforcement actions, including cease and desist orders, individuals removed or prohibited, and consent merger resolutions and agreements, was 73. According to information from the OTS, there was only one Supervisory Agreement in Arkansas in 1984, implying it must be the one imposed on Madison. According to the information from the OTS, it was the only Supervisory Agreement in Arkansas from 1982 to 1986. There was, however, one cease and desist order imposed on a savings and loan in Arkansas in 1984. From 1980 through 1984, there were no regulatory seizures or resolutions in Arkansas. Nationwide from 1980 through 1984 there were 160 resolutions, with 22 in 1984.

Actions of the State Regulator Before January 18, 1985

A central focus in evaluating the regulation and supervision of Madison has been the role of the state regulator of state-chartered savings and loans in Arkansas. As mentioned above, the Arkansas Securities Commissioner, as head of the Arkansas Securities Department, was the state regulator of state-chartered savings and loans. The Arkansas Securities Commissioner from 1981 through January 18, 1985 was Lee Thalheimer, who had been appointed by Governor Frank White.

The relationship between state and federal regulators of savings and loans and the regulators' individual and joint responsibilities is complex. Under differing circumstances, the state regulator acting independently of federal regulators may revoke a state charter of a savings and loan if, for example, it is insolvent. The federal regulator cannot revoke a state charter. The federal regulator, however, under certain circumstances can revoke federal deposit insurance for an institution independently of the state regulator. We know of no instance in which this was done in the 1980s. In general, as the savings and loan industry was devastated in the 1980s, state and federal regulators responded jointly to the problems affecting state-chartered institutions. We know of no instance, for example, when an insolvent state-chartered, federally insured savings and loan was seized and resolved without the ultimate joint action of state and federal regulators.

In answer to questions about the seizure of Madison, the OTS has described the relationship between federal and state regulators in the context of Madison as follows: "Consistent with the structure established by Congress, Madison S&L was chartered by the State of Arkansas, insured by the FSLIC, and jointly regulated by the FHLB system and the State...." Because of the limited staff of the Arkansas regulator, "The state of Arkansas relied heavily upon the federal regulators to perform its oversight duties...." Conversely, one may presume under such circumstances that federal regulators were not relying heavily on the Arkansas regulator for financial information about the condition of state-chartered institutions.

Our understanding is that the Arkansas Securities Department at all times in the 1980s had access to all relevant and material information about Madison's financial condition, compliance with regulations, and federal regulators' other evaluations of Madison. It is our understanding that the department had access to the information without material delay. It is also our understanding that in general the department had the legal authority to obtain any relevant and material information it needed directly from Madison, if it chose to do so.

In January of 1984 the federal examination report concluded that if selected profits were properly accounted for Madison would have been rendered insolvent. The supervisory agent did require that some accounting changes be made. As a result, Madison may have failed to meet its minimum capital requirement. The federal examiners and supervisors indicated other unsafe and unsound practices. Based on this information, the FHLBB, as head of the FSLIC, could probably have taken action that would have led to the seizure of Madison. It did not seize Madison or several hundred other institutions that were already—unlike Madison—reporting insolvency. Instead, it entered into a Supervisory Agreement with Madison.

It is our understanding that the Arkansas Securities Department had access to Madison's financial statements filed with the FHLBB, the relevant federal examination reports, supervisory correspondence, and the Supervisory Agreement. In 1984, based upon this information, one might argue that the department could have encouraged the FHLBB to examine more closely whether Madison met its minimum capital requirement or was in fact insolvent. Given the acknowledged unsafe and unsound practices, the possible failure of Madison to meet its capital requirement, and its composite examination rating of 5, one might also argue that the department should have begun a process to evaluate whether Madison should be seized and resolved.

Based on the information available to us, however, this was not done. Neither the federal nor the state regulators sought to seize and resolve Madison in 1984. Both relied on the Supervisory Agreement to correct what were perceived to be unsafe and unsound practices and thereby to improve Madison's condition.

IV. WHAT THE REGULATORS KNEW AND WHEN THEY KNEW IT AFTER JANUARY 18, 1985

Madison's Continued Growth and Deterioration in 1985 and Thereafter

As Chart 2 shows, between year-end 1984 and year-end 1985, Madison's assets rose from the year-end 1984 level of \$48.6 to a year-end 1985 level of \$107.7, a one-year growth rate of 120 percent. Madison also continued a pattern of behavior begun in 1983 in which its share of home-mortgage loans declined and its share of commercial real estate loans and investments dramatically increased. Its tangible capital ratio rose slightly to 1.6 percent at year-end 1985.

Under the circumstances, these developments are shocking. Despite the manifest problems uncovered by the previous examinations and despite the Supervisory Agreement, Madison was allowed to more than double in size—and increase of \$59.1 million—with no corresponding increase in capital provided by the owners. Despite previous continuous findings by the examiners of problems with Madison's commercial real estate loans and investments, these types of loans and investment also increased substantially.

The March of 1986 report of examination stated that "... management blatantly disregarded numerous regulations, including the growth regulation. It is also apparent that certain provisions of the August 6, 1984 Supervisory Agreement were ignored." The examination also stated that Mr. McDougal "effectively controls the affairs of the Institution ... this control enabled Mr. McDougal to use corporate resources to develop large land developments. It also enabled him to divert substantial amounts of funds from the projects to himself and others who are considered insiders (relatives of Mr. McDougal, employees, relatives of employees and friends.)"

The report of examination also stated that "Madison Guaranty has not met the capital requirement for any quarter in 1985 or 1986." As was the case with the 1984 examination, the proper recognition of profits was an issue in 1986. The examination noted that a large portion of profits associated with sales of land "... were taken into income immediately. This accounting treatment is improper ... Instead, the profits should have been deferred. If the profits were booked properly, the Institution would be, in fact insolvent." If the profits had been deferred, examiners estimated "that there would be a negative capital of over \$1 million"

On April 2, 1986, the Office of Examination and Supervision of the Federal Home Loan Bank of Indianapolis made an Interim Report on Madison. The report noted that "neither the Board or management have complied with ..." the Supervisory Agreement of 1986. The report noted continued problems with capital, transactions with affiliated persons, incomplete classification of poorly performing loans, and other deficiencies. A second Interim Report on May 8, 1986 referred to the previous Interim Report's finding "that management

has intentionally evaded compliance with the Supervisory Agreement...." and was continuing to do so.

A third Interim Report on June 10, 1986 found that it was "difficult to obtain information from Mr. Latham and Mr. McDougal. They appeared to be attempting to learn as much as possible about the findings of the examination without responding to our questions." Mr. Latham was then the chairman of the board of directors of Madison. The report stated that management was "not responding to our questions. Instead, ... they ask the examiners questions about our sources of information." The report also noted that Madison's management had asked examiners to submit questions in writing through only one official. The report noted that the result of such a process would be that "The examination will have essentially ceased to produce any findings not previously approved by management."

On June 17, 1986 the Federal Home Loan Bank of Dallas requested that the FHLBB issue a cease and desist order to Madison based on the numerous regulatory violations, unsafe and unsound practices, and violations of the Supervisory Agreement. A cease and desist order was issued on August 15, 1986. At that time, Mr. McDougal was removed from the management of Madison.

In June 1986 and thereafter Madison reported losses. As Chart 2 shows, Madison's total assets peaked at year-end 1986 at \$125.5 million, an increase of 17 percent over the year-end 1985 level. The assets declined thereafter, to \$91 million in June of 1990. As the chart also shows, Madison's tangible capital dropped precipitously in 1987, plunging to a negative 11 percent of assets from 1.7 percent at year-end 1986. Despite reporting insolvency, Madison was not seized for another two years, during which time the negative tangible capital that it reported to regulators more than doubled to a negative 24 percent.

From 1985 through 1988, there were six resolutions in Arkansas, one of which was a state-chartered institution. It was the smallest institution resolved with \$10 million in assets, and was resolved in 1988. These six institutions cost less per dollar of assets than Madison and the other Arkansas savings and loans seized in 1989.

Actions of the State Regulator after January 18, 1985

On January 18, 1985, Beverly Bassett Schaffer, then Beverly Bassett, was appointed the Arkansas Securities Commissioner by then Governor Bill Clinton. She held the position until January of 1992. At issue is whether in her capacity as the Arkansas regulator of state-chartered savings and loans she gave Madison undue favorable treatment because Mr. McDougal was a friend and business partner of Governor and Mrs. Clinton. Also at issue is whether she influenced or attempted to influence federal regulators to provide undue favorable treatment to Madison in their capacity to act independently of the state regulator or in concert with the state regulator.

Ms. Schaffer has provided the press with a chronology of events associated with Madison that indicates that she and her department were aware of the FHLBB reports of examination regarding Madison before and after her appointment. The chronology indicates that she and her department were aware of correspondence and meetings between officials of Madison and the FHLBB before and after her appointment. The chronology also indicates that she and the staff of the department regularly discussed issues and participated in meetings with federal regulators regarding Madison. It is our understanding, then, that Ms. Schaffer and her department at all times were informed on a timely basis about the financial condition and other activities of Madison.

Ms. Schaffer and her predecessor appear to have accepted without resistance recommendations for the Supervisory Agreement in 1984 and the Cease and Desist Order and removal of Mr. McDougal in 1986. So far, we have seen no information indicating that they encouraged or persuaded federal regulators to take either more lenient or harsher action than the federal regulators intended to take and did take. It is clear that the regulatory actions taken regarding Madison by the federal and state regulators throughout the 1980s were grossly inadequate.

Although the federal regulators shouldered the *de facto* primary regulatory responsibility for Madison, Ms. Schaffer should have begun the process in 1985, as she ultimately did in 1987, that preceded Madison being seized and resolved. Especially after Madison grew by \$59 million in 1985 and another \$18 million in 1986, the findings of improperly booked profits and insolvency of \$1 million in the March of 1986 report of examination, insider dealings, and disregard of the Supervisory Agreement, no form of federal or state regulatory tolerance or forbearance was justified. Madison's condition was getting far worse despite previous enforcement actions, and its continued growth in assets was exposing FSLIC, and thereby taxpayers, to still bigger losses. Based on information available to us, neither the federal nor state regulators took sufficiently strong or timely enforcement action against Madison in 1985 and 1986. This undoubtedly resulted in greater cost to resolve Madison.

An issue exists concerning the inquiry on April 30, 1985 by the Rose Law Firm on behalf of Madison about "whether an Arkansas chartered Savings and Loan Association may under Arkansas law create, authorize and issue a class of preferred stock...." and Ms. Schaffer's May 14, 1985 response that "... Madison's proposed capitalization plan is not inconsistent with Arkansas law." For various reasons, many troubled savings and loans at that time were interested in adding to their capital by issuing preferred stock or subordinated debt. Whether the issuance of preferred stock by Madison was intended simply to raise capital or to fuel even greater growth in its non-traditional assets (that would have produced correspondingly bigger losses) is unknown to us.

Ultimately, Madison did not issue preferred stock. Before having actually issued such a security, however, it would have had to obtain approval from the FHLBB.

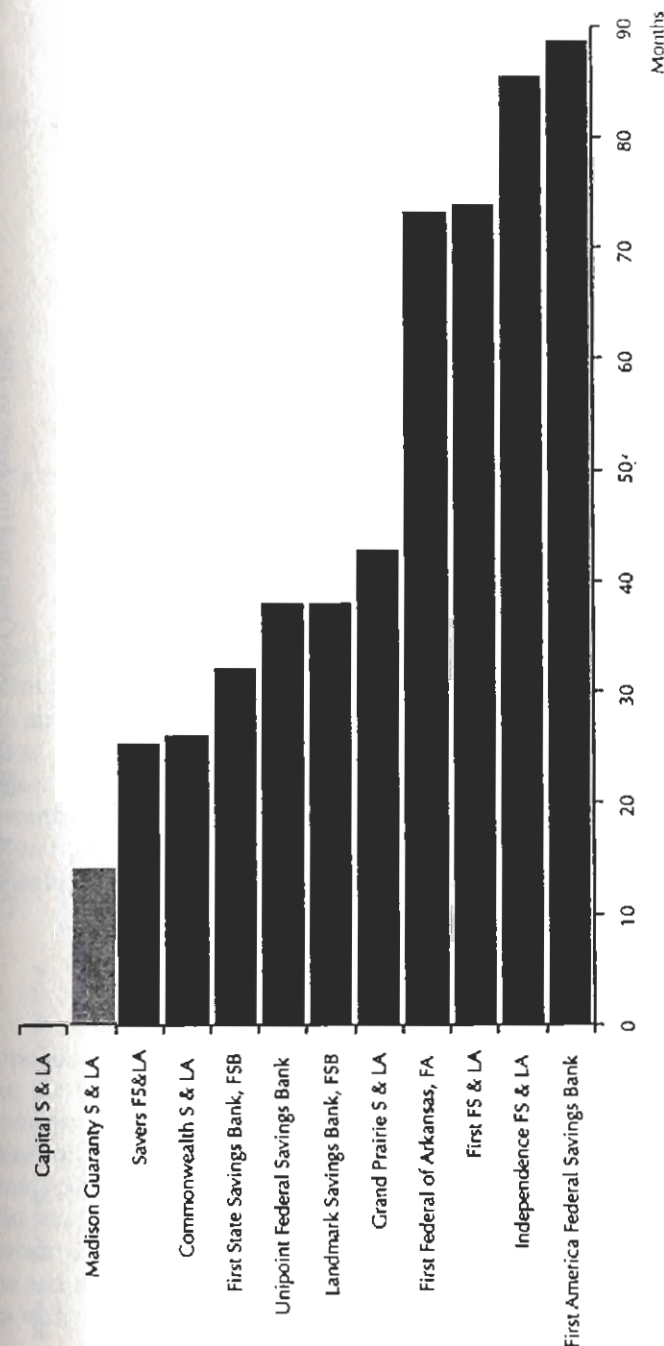
In December of 1987 Ms. Schaffer wrote a letter to the FSLIC citing Madison's reported regulatory insolvency and requesting that Madison be transferred to the FSLIC. On May 10, 1988 Madison signed a consent merger agreement, agreeing to a merger resolution if one could be arranged by FSLIC. None was arranged. On May 15, 1988 Madison was transferred from the regular examination and supervision staffs to the FSLIC as a FSLIC case in need of resolution. On December 29, 1988, the Federal Home Loan Bank of Dallas formerly requested that the FHLBB appoint FSLIC as a liquidating receiver for Madison. Madison was seized in March of 1989.

V. THE SEIZURE AND RESOLUTION OF MADISON

Madison was not the only institution seized in 1989. In Arkansas in the beginning of that year, for example, eight federally chartered savings and loans that would ultimately be seized were still open while reporting insolvency to federal regulators. The state was not responsible for those savings and loans. Madison was one of four insolvent state-chartered savings and loans that would be seized but were still open in the beginning of 1989.

Although Madison had been reporting insolvency since the end of 1987, ten of the eleven other institutions seized in 1989, including all the federally chartered institutions, had been reporting insolvency longer. Independence Federal had been reporting insolvency every year since year-end 1981, First Federal of Arkansas, First Federal (of Fayetteville), and First American Federal since the end of 1982, Unipoint Federal and Landmark Savings Bank (federal) since the end of 1985, First State Savings Bank (federal) and Grand Prairie (state) since June 1986, Savers Savings Association (federal) and Commonwealth (state) since the end of 1986, and Capital (state) in June 1989. Chart 3 shows the total number of months all the institutions were open while reporting insolvency to the regulatory authorities. Nationwide, institutions that were seized in 1989 had been reporting tangible insolvency to federal regulators on average for 42 months.

As Chart 4 shows, according to the most recent estimates of the RTC, Madison cost an estimated \$73 million to resolve. Four other Arkansas savings and loans that were insolvent in 1989 were resolved at greater—and in some instances substantially greater—cost, and they were all federally chartered institutions. First Federal of Arkansas cost \$833 million, Savers Savings Association \$645 million, Independence \$314 million, and Landmark Savings \$91 million. Overall, as Chart 5 shows, Madison cost only 3.3 percent of the



Sources: OTS Resolved Conservatorship Report, OTS Thrift Financial Reports.

Chart 3. Arkansas S&Ls Open and Insolvent in 1989
Months Tangible Insolvent Before Seizure

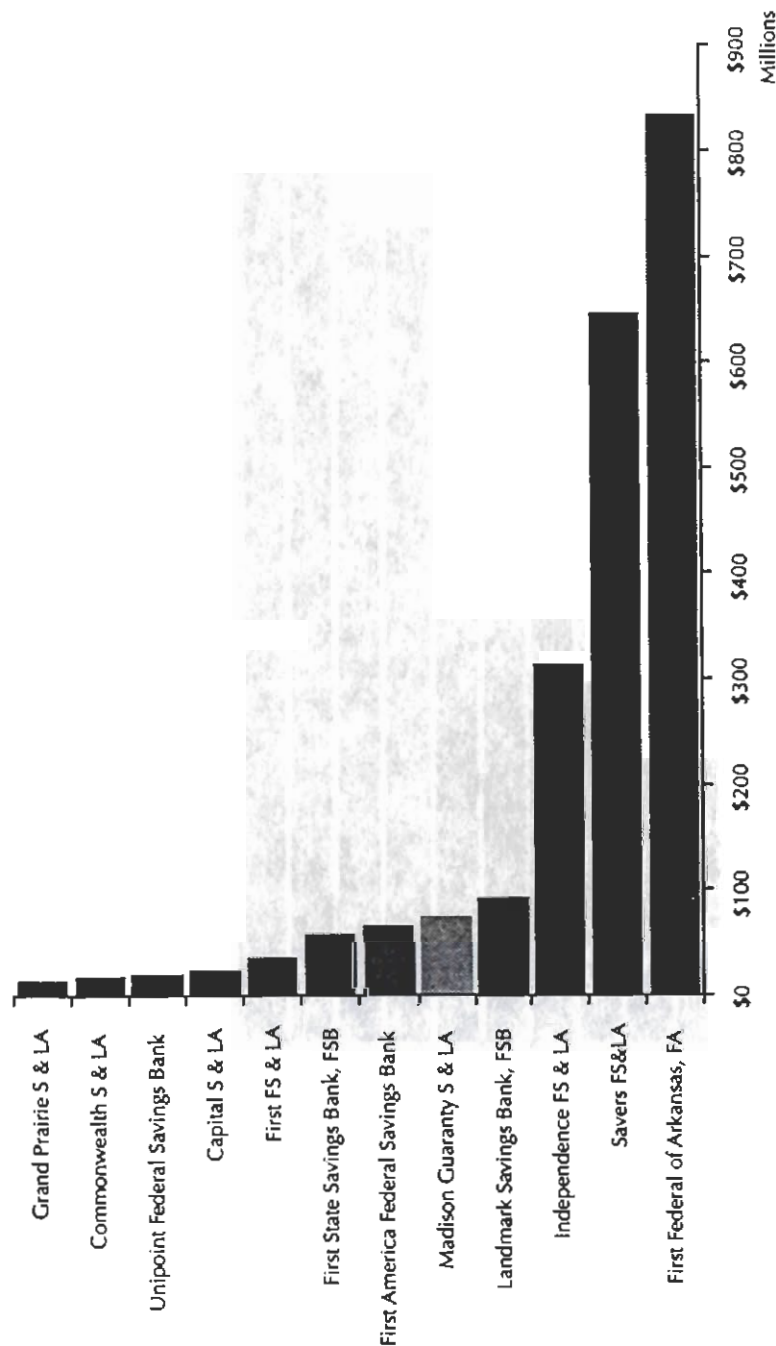
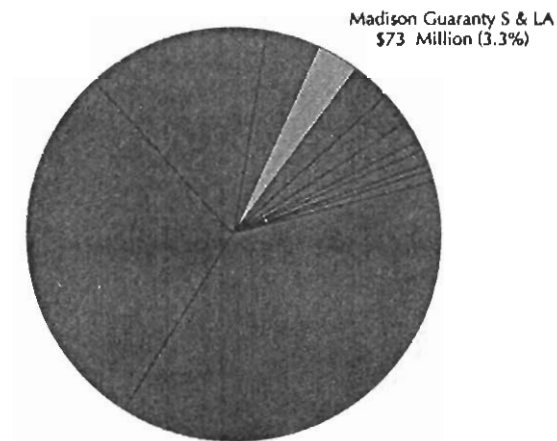


Chart 4. Arkansas S&Ls Open and Insolvent in 1989
Estimated Cost of Resolution

Source: RTC Data on Selected RTC Institutions.

Total Estimated Resolution Costs:
\$ 2.184 Billion



Source: RTC Data on Selected RTC Institutions.

Chart 5. Arkansas S&Ls Open and Insolvent in 1989
Madison Guaranty's Share of Estimated Resolution Costs

total estimated resolution cost of institutions, which like itself, were open but insolvent in Arkansas in part of 1989 before being seized.

In a similar vein, the cost of resolving Madison represented 61 percent of its assets. Yet, as Chart 6 shows, one of the federally chartered institutions cost more than 100 percent of their assets in 1989 to resolve and another cost 96 percent of assets. In total, three of the institutions that were insolvent like Madison in 1989 cost more than Madison to resolve per dollar of assets, and all of them were federally chartered.

VI. THE TIMING OF THE SEIZURE AND RESOLUTION OF MADISON

In responding to questions about why Madison was not resolved earlier than it was, the OTS has explained that "In light of the conditions elsewhere in the industry, the financial and managerial resources of the FSLIC, the size of Madison Guaranty S&LA, and the actions taken to stabilize Madison Guaranty S&LA, the FSLIC assigned Madison a lower priority." At issue then is what were the prevailing conditions, what were the resources of the FSLIC, and where did Madison fit into the picture?

The seizure process for savings and loans throughout the 1980s typically began with the examiners and supervisors in the relevant Federal Home Loan

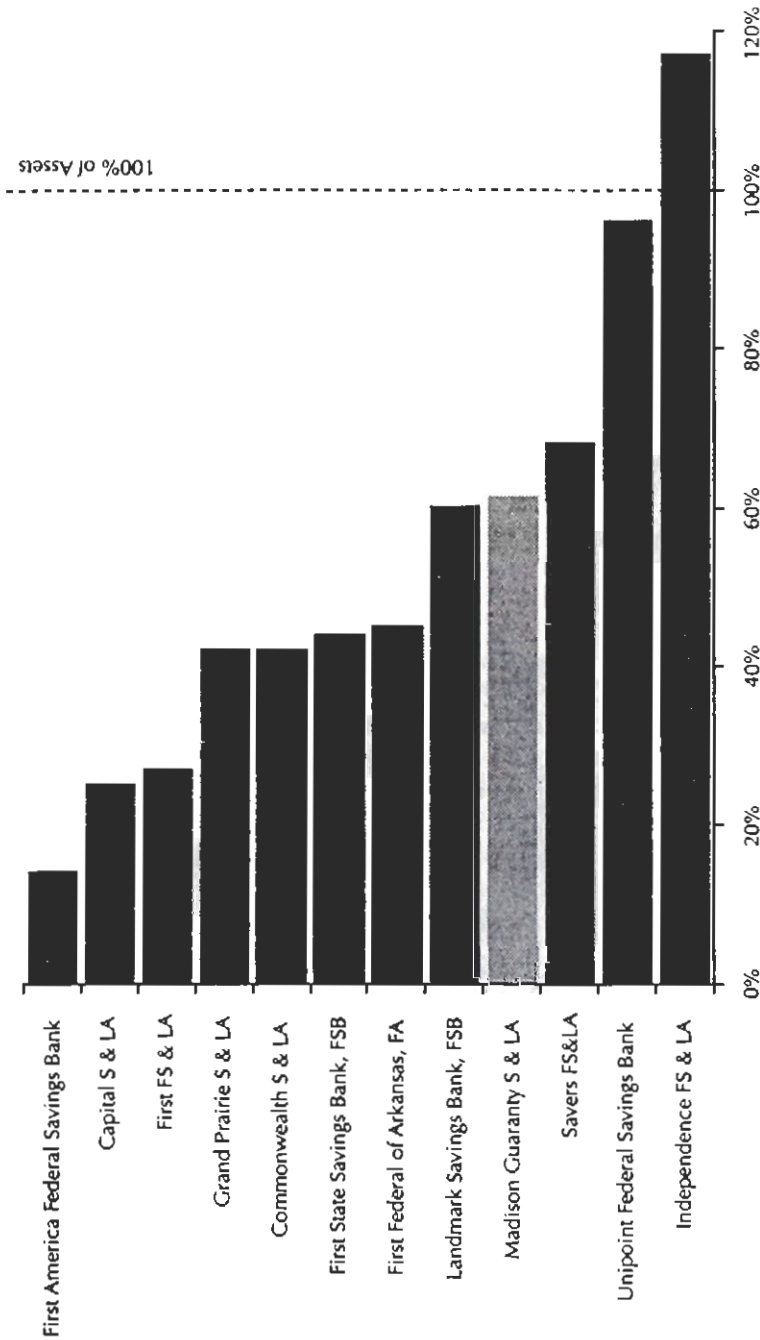


Chart 6. Arkansas S&Ls Open and Insolvent in 1989
Estimated Cost of Resolution as a Percent of Total Assets

Source: RTC Data on Selected RTC Institutions.

Bank District, as the record regarding Madison reflects. As mentioned above, Madison was in the district that included Texas. By 1986, 50 percent of the savings and loans (a total of 246 institutions) in that district were reporting losses, and 65 percent (a total of 311 institutions) did so in 1987. The problems were so extensive that federal examiners and supervisors from other districts around the country were sent temporarily to assist in monitoring all the troubled savings and loans in Madison's district. This explains why the Federal Home Loan Bank of Indianapolis conducted the three interim examinations of Madison in 1986.

At year-end 1987, there were 186 institutions in the ninth district reporting insolvency based on Generally Accepted Accounting Principles (GAAP). The institutions had \$60 billion in assets and were reporting negative tangible capital of \$16 billion and negative income of \$7.3 billion. At this time, Madison's \$111 million in assets represented two one hundredths of one percent of the total assets of insolvent institutions in the ninth district, and its \$12 million negative capital represented eight one thousandths of one percent of the total negative capital reported in the district.

Nationwide in 1987, 520 institutions were reporting GAAP insolvency, with \$183 billion in assets, and \$11 billion in negative net income. The extent of the difficulties in the ninth district can be seen in the nationwide context in that 36 percent of the nation's insolvent institutions with 33 percent of the assets were in the ninth district.

Timely resolution of troubled federally insured savings and loans during the 1980s was the primary responsibility of the FSLIC. Throughout the period, however, it was without sufficient resources to resolve all insolvent savings and loans. The FSLIC itself reported insolvency of \$6.3 billion in 1986, which rose to \$13.7 billion in 1987 and the \$75 billion in 1988.

Although FSLIC did not report insolvency until the issuance of its annual report for 1986, its actual financial condition had been overstated for some time. In a paper widely circulated in Washington in the spring of 1985, we stated for the first time that the FSLIC was insolvent. At a Senate hearing in July of 1985, Senator William Proxmire, then the Chairman of the Senate Banking Committee, confronted Edwin Gray, then the Chairman of the FHLBB, with our estimates showing insolvency. Chairman Gray rejected them stating that the \$15.8 billion in costs that we estimated were necessary to resolve all GAAP-insolvent savings and loans were a "worst case scenario" that was unlikely to occur.

Neither Senator Proxmire nor the then ranking minority member of the committee, Senator Jake Garn, disagreed with him. This exchange was widely reported at the time. Shortly thereafter, the *Washington Post* wrote two editorials describing our findings in detail. Thus, just at the time that Madison was considered insolvent by examiners, and large numbers of other savings and loans were being kept open while insolvent, the Congress—despite

available credible warnings—did not address the crucial issue of FSLIC's funding.

Congress did not address the issue until August of 1987 when it provided FSLIC with the ability to borrow up to \$10.8 billion over several years. In an op/ed piece in the *New York Times* in July of 1987, we wrote that "The bill would raise an inadequate sum from a source that seems unable to pay it." We also pointed out that "Constraining the risk-taking of insolvent but open thrifts depends on examiners, supervisory personnel and the threat of legal action by the Federal Home Loan Bank Board. By all Bank Board accounts this risk-containment mechanism is thoroughly strained. Costs will rise as a result." We concluded that "Congress should fund a program that would allow ... a multiyear approach to closing insolvent thrifts. Because hundreds of them cannot be closed at once, an army of examiners, supervisors, lawyers and accountants must be conscripted to control the risk-taking of insolvent associations."

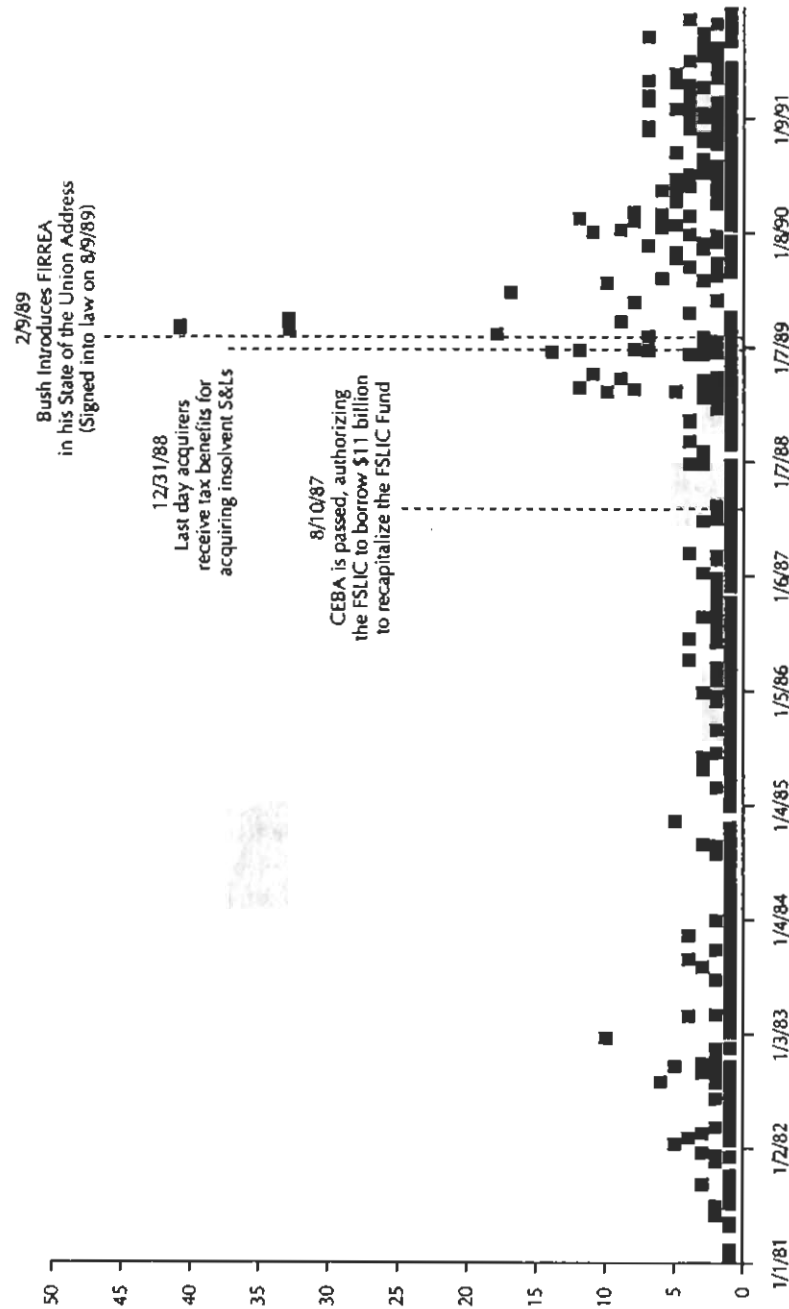
The effort needed to provide appropriate resources to resolve insolvent institutions did not begin until 1989, when President Bush requested that Congress commit taxpayer dollars to the clean-up. As Chart 7 shows, the number of savings and loan seizures per day was relatively low and stable until 1988. As Chart 7 shows, the number of seizures rose dramatically in that and subsequent years. In February of 1989 President Bush introduced in his State of the Union Address what would become the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). FIRREA, enacted in August of 1989, was the first legislation that directly provided taxpayer dollars for the final clean-up of insolvent savings and loans. Madison and many other savings and loans were finally seized during that time.

VII. CONCLUSIONS

Systemic Regulatory Failure

Based on this review, with the exception of one element, the lengthy federal and state regulatory tolerance of the behavior and associated deteriorating performance of Madison reflected a systemic failure of the regulatory and supervisory system from top to bottom and from beginning to end. The one element that worked relatively well—the examination process—actually makes the remaining regulatory failures more striking.

The examination process appears to have uncovered with remarkable accuracy beginning with the report of the Special Limited Examination in April 1982 the difficulties that evolved into Madison's costly failure. Throughout Madison's existence, the examination process continuously and repeatedly provided the appropriate federal and state decision makers with accurate and



Sources: FHLBB/OTS TFRs, FHLBB/OTS Press Releases, and FHLBB/OTS List of Mergers and Deletions.

Chart 7. Number of Seizures per Day 1981-1991

ever more disturbing information to take necessary enforcement actions. The financial reports filed with federal regulators also depicted Madison's evolution and deterioration. The federal and state decision makers, however, never took sufficiently strong or timely actions that would have been appropriate to contain, if not eliminate, the cost of Madison's failure.⁷

There is no doubt whatsoever that beyond 1982 Madison should not have been allowed to grow in the way in which it did. By the end of 1984, grounds for the seizure of Madison almost certainly existed based on unsafe and unsound practices and probably insolvency, although there is some ambiguity about the correct recognition of profits at that time. It was certainly appropriate to impose the Supervisory Agreement in 1984, which included a requirement that Madison meet its minimum capital requirement.

The March 1986 examination reiterated that the proper accounting for profits would have rendered the institution insolvent, but now by \$1 million. That examination also emphasized that Madison had flagrantly disregarded the Supervisory Agreement. The 1987 examination concluded that the appropriate recognition of profits would have rendered the institution insolvent by the end of 1985. This indicates that although Madison reported tangible insolvency for 15 months before it was seized, it was actually insolvent 39 months before it was seized.

The continued extraordinarily high rates of growth in 1985 and 1986 are particularly shocking. In those two years alone, Madison grew by \$76.9 million, more than the estimated cost to resolve it. Although high growth rates had been a national problem, they were beginning to abate in 1985. In 1983 and 1984, the annual growth rate of total assets of all savings and loans was 19 and 20 percent, respectively. In 1984 the annual growth rates in the states that ultimately suffered the greatest losses were 47 percent in Arizona, 30 percent in California, 21 percent in Florida, and 38 percent in Texas.

Under regulatory pressure nationwide, the annual growth rate of assets of all savings and loans had fallen to 10 percent in 1985. In 1985 the growth rates had fallen to 24 percent in Arizona, 9 percent in California, 8 percent in Florida, 18 percent in Texas. To have knowingly allowed an institution in Madison's condition to have grown by 120 percent in 1985 is astounding.

The regulatory tolerance of the apparent flaunting of the Supervisory Agreement in August of 1984 and of the continued practices thereafter that were characterized repeatedly as unsafe and unsound is also shocking. This type of regulatory behavior may help explain the fact that by year-end 1988, the 9 state-chartered savings and loans in Arkansas were reporting a tangible capital-to-asset ratio of negative 2 percent. In contrast, the 1,220 nationwide state-chartered institutions were reporting a positive 1 percent. In general, Arkansas savings and loans at the time held riskier assets and were in worse financial condition than institutions nationwide.⁶

FSLIC's Resources and the Timing of Regulatory Action

By year-end 1986 Madison's growth peaked and thereafter declined. Again, in answer to questions about why Madison was not resolved earlier, the OTS has stated that "Due to the financial condition of the FSLIC and the volume of insolvent associations, the policy of the FHLBB and the FSLIC ... was to take a three step approach ... The first step was to stabilize associations by replacing management responsible for existing problems, limiting growth, and restricting investments in high-risk assets...." This goal was not achieved in a timely manner, although Mr. McDougal and another executive were removed and a cease and desist order was imposed in 1986.

According to the OTS, the second step of determining whether a resolution without FSLIC assistance was possible was concluded in the negative in May of 1988, when the third step was taken by transferring Madison to the FSLIC for an assisted resolution. Then, apparently due to its low priority, Madison was not resolved until 1989. According to the OTS, "The FSLIC prioritized insolvent associations based upon size and degree of stability.... as well as the condition of the FSLIC ... to determine the order in which to resolve the 1987 and 1988 FSLIC caseload."

In essence, until Congress made taxpayer funds available in 1989, the FSLIC was engaged in a complex triage operation nationwide in which it tried to contain the problems associated with a large number of open but insolvent federally insured savings and loans.⁷ Madison is one example where the triage operation was not able to contain the growth and excessive risk-taking that contributed to Madison's ultimate cost of resolution.

Relationship Between Federal and State Regulators

The relationship between the federal and state regulators remains an issue. The defining element of that relationship is the existence of federal deposit insurance, which ultimately, as is now so widely known, is the responsibility of federal taxpayers. Federal regulators cannot tolerate individual state regulatory decisions that increase inappropriately the risk of loss to federal taxpayers. As a result, federal regulators will always shoulder the *de facto* primary responsibility for institutions operating with federally insured deposits regardless of whether they are state-chartered. One cannot imagine Congress wanting it otherwise.

A conclusion that Madison was somehow unique in its collapse and the costs that it imposed on federal taxpayers because it received special treatment or leniency from state regulators does not appear to be supported by the information we have reviewed. The behavior and performance of Madison and the response by the regulatory authorities, nonetheless, is clearly disturbing.

How to Shed More Light on the Savings and Loan Debacle

As the Madison case makes clear, the examination reports and supervisory correspondence can reveal a considerable amount of valuable information. Congress could evaluate the wisdom of one action that would shed substantial light on the entire savings and loan debacle—including the role of both state and federal regulators. It could hold a hearing on the need for a law that would make all examinations and supervisory records publicly available for failed federally insured savings and loans and banks.⁸ With enactment of such a law everyone would then be far better able to determine who knew what and did what when. After all, more than 4,500 federally insured institutions have failed over the past 15 years. Unless regulatory agencies disclose the necessary information, how can they ever be held accountable to the public?

NOTES

1. This paper is based on testimony we prepared for hearings before the Committee on Banking and Financial Services of the House of Representatives on August 7, 1995, the so-called Whitewater hearings. The hearings focused on regulation of Madison, aspects of the Whitewater real estate investment, and the resolution of Madison by the Resolution Trust Corporation (RTC). The testimony focused on the condition, regulation, and seizure of Madison Guaranty Savings and Loan Association in the 1980s.
2. The following books provide more detailed information on the turmoil in the U.S. depository industry: Brumbaugh (1993), Barth, Brumbaugh, and Litan (1992), Barth and Brumbaugh (1992), Barth and Bartholomew (1992a), Barth (1991), White (1991), Kane (1989, 1985), Kaufman (1989), Brumbaugh (1988), Kaufman and Kormendi (1986), Benston, Eisenbeis, Horvitz, Kane, and Kaufman (1986), Balderston (1985), and Carron (1984, 1983, 1982).
3. For a summary of estimated losses for commercial banks, savings and loans, and credit unions, see Barth, Page, and Brumbaugh (1992, p. 12). For a summary of the cost estimates made in the 1980s by the Federal Home Loan Bank Board, other federal government agencies, and private analysts, see Barth (1991).
4. For an excellent discussion of alternative measures of capital for federally insured depositories, including limitations of the accounting values of capital used for regulatory purposes, see Kaufman (1992). For a description of changes in the capital regulations in the early 1980s that among other things allowed minimum regulatory capital to decline to the levels reached by Madison, see Barth (1991) and Brumbaugh (1988).
5. The structured early intervention and resolution (SEIR) provisions of the Federal Deposit Insurance Corporation Act of 1991 (FIDICIA) were designed to ensure that this pattern was not repeated. The provisions established a set of rules that require that prompt regulatory intervention and if necessary closure and resolution as an institution deteriorates. For a partial history of FIDICIA, see Barth (1991, pp. 62-64, 114, 116) Barth, Brumbaugh, Sauerhaft, and Wang (1986, 1989), Barth, Brumbaugh, Sauerhaft and Wang (1986), Barth and Brumbaugh (1994), Benston and Kaufman (1988), Benston, Brumbaugh, Guttentag, Herring, Kaufman, Litan, and Scott (1989), Brumbaugh (1988, pp. 123-128, 172, 173), and Statement No. 38 of the Shadow Financial Regulatory Committee "An Outline of a Program for Deposit Insurance Reform" in Kaufman (1992).

6. For discussions about the presence or absence of moral hazard in risk-taking in the savings and loan debacle, see CBO (1991), Barth, Bartholomew, and Bradley (1990), Barth, Bartholomew, and Whidbee (1989), Barth, Bartholomew, and Labieh (1990), and Brewer (1990), Benston and Carhill (1994), and Gorton and Rosen (1991), Benston and Koehn (1989), Brickley and James (1986), and Garcia (1988).
7. See Romer and Weingast (1992) for an analysis of the savings and loan debacle based on public choice theory and evaluation of congressional behavior.
8. For an extensive reform agenda, see Barth and Brumbaugh (1994).

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