THE SAVINGS AND LOAN CRISIS:
CAUSES AND CONTRIBUTORS

AN HONORS THESIS
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Purpose of Thesis

This discussion of the savings and loan crisis explores the causes of the crisis and those who contributed to it. The paper begins by exploring the history of the savings and loan industry and the events that led to the crisis of the 1980's. It then explores the factors and people who have been targeted as contributors to the crisis, specifically the accounting profession. Finally, the future of the thrift industry is addressed.
It will be several years before the realization of the full extent of the savings and loan crisis is known. Critics have tried to fix blame for the crisis on the accounting profession. Through an examination of the history of the savings and loan industry, we can begin to understand the factors contributing to the crisis. By analyzing the role of the accounting profession throughout the crisis, we can understand why much of the criticism directed toward the profession is unwarranted. It is hoped that by understanding the mistakes of the past, we can begin to address the mistakes that were made and take corrective action to ensure that the future of the savings and loan industry is a stable one.

HISTORY

Savings and loan associations were established in the 1930's to serve the needs of new homebuyers. Under the direction of the Federal Home Loan Bank Board, S&Ls were allowed to accept deposits in passbook savings accounts and then invest these deposits in residential mortgages. Savings and loans, often referred to as thrifts, were formed with federal or state charters. A thrift with a federal charter was subject to federal government regulation while state-chartered thrifts were subject to state regulation. State-chartered thrifts were also governed by federal regulators if they obtained federal deposit insurance. Savings and loans deposits became federally insured (up to $5,000) in 1934 with the establishment of the Federal Savings and
Loan Insurance Corporation (FSLIC).

Savings and loans began to grow in the 1930's with help from the federal government. In addition to the depositor protection offered by the FSLIC, the Federal Housing Administration was established to aid homebuyers who could not afford the traditional twenty percent down payment required of first time home buyers. Government organizations, Fannie Maes, were formed in 1938. These organizations bought mortgages from lenders thereby increasing the supply of funds for others (White, 1991). Because of this support from the government, S&Ls enjoyed a very stable and profitable environment throughout the 1950's. The industry moved into the 1960's expecting to continue to profit; instead, it discovered that as interest rates rose sharply thrifts had no way to avoid heavy losses due to an interest rate squeeze.

The regulation under which S&Ls operated forced them to "borrow short and lend long". They found themselves tied into fixed-rate, thirty-year mortgages while paying interest on passbook savings funds that could be withdrawn at any time. During the growth period experienced in the 1950's, thrifts could offer home mortgages and perhaps charge the borrower six percent interest while offering those who deposited with the thrift perhaps a three percent return. When interest rates rose sharply in the early 1960's, S&Ls were forced to respond by raising the rates on passbook savings. Because the interest rates on the mortgages were fixed over the lives of the loans, the profits of
the thrifts decreased when interest rates on savings accounts increased substantially. To combat this problem S&Ls could have chosen to lower the interest rates on passbook savings accounts. Thrifts realized, however, that as soon as they lowered interest rates, customers would withdraw their funds and the thrift would struggle to survive financially. The only other alternative would be to sell off the older fixed-rate mortgages and hope to issue new mortgages at more favorable rates. This alternative seemed to provide only a short-run solution for the thrift because the basic problem of borrowing short and lending long was not solved.

The government responded to this crisis by adopting "Regulation Q" in 1966. Regulation Q placed a ceiling on the interest rates thrifts paid on savings deposits. This rate was deliberately set at a slighter higher rate than that of commercial banks. Banks complained about this differential but regulators argued that the difference was fair due to the narrower range of services offered by the savings and loans. Regulators hoped that by enforcing Regulation Q thrifts would not have to attract customers away from banks by raising interest rates and the interest rate squeeze would no longer be a factor. Regulation Q was an effective way of dealing with the rising interest rates of the late 1960's and early 1970's.

The oil crisis of the 1970's sent inflation into the double-digits and higher interest rates were now being found outside of the banking industry. Thrifts could no longer compete with
investment returns that were offered elsewhere and investors began to look for investments that would prove more lucrative.

The 1970's saw the emergence of money market mutual funds. Depositors who had previously invested in the higher-rate savings accounts offered by savings and loans were now turning to the higher return being offered through the mutual funds. Savings and loans, which had succeeded in combatting the high interest rates through Regulation Q, suddenly faced increased competition. Depositors began to withdraw their funds and savings and loans were once again in trouble.

In 1980 Congress attempted to control the problems of the savings and loan industry by enacting the Depository Institutions Deregulation and Monetary Control Act (DIDMCA). The act allowed thrifts to place twenty percent of their assets into short-term, market-rate investments, thus increasing their liquidity. It also expanded thrift services to include interest-bearing checking accounts, trust services, and credit cards. DIDMCA also increased federal deposit insurance from $40,000 to $100,000. By increasing the federal deposit insurance many thrift managers were now able to gather even more funds through brokered deposits and the expansion of services. Unfortunately the deposits were now being placed in the risky investment areas made available under DIDMCA. A final provision of the act was the formation of a committee to phase out the interest rate constraints enacted under Regulation Q (Laughlin, 1991).

DIDMCA tried to encourage investors to place money with
thrifts, however, deposits continued to flow out of thrifts at a record pace due to the lack of implementation for a phase out of interest rate ceilings that was scheduled to take place in 1980. In 1981, outflows from thrifts exceeded inflows by 25.5 billion dollars (Laughlin, 1991). Federal Home Loan Banks were forced to make loans to thrifts to avert an industry-wide collapse. In 1981 the FHLBB authorized federal thrifts to issue Adjustable Rate Mortgages (ARMs) in an effort to more closely match revenues and expenses.

The Garn-St. Germain Act of 1982 further expanded the powers of federally-chartered thrifts to engage in non-traditional investments. Under this act, federally-chartered thrifts could engage in commercial loans, ARMs, and consumer loans. Many state-chartered thrifts switched to federal charters in an effort to capitalize on the expanded asset powers of Garn-St. Germain. Pressured by the provisions of the Garn-St. Germain Act and hoping to keep their state-chartered thrifts, many states also expanded their state-chartered thrifts' asset powers. In order to attract state-chartered thrifts, other states (most notably, Texas, California and Florida) allowed their state-chartered thrifts even wider asset powers than those powers enacted under the Garn-St. Germain Act. Because many thrifts were already in financial trouble, however, they were slow to invest the needed resources into ARMs and the industry continued to flounder.

The depressed state of the savings and loan industry prompted continuous action by the FHLBB. Federal officials
believed that, given time, interest rates would return to previous levels and the industry would return to profitability. Many thrifts, however, were already below the existing net worth requirements, leaving them subject to regulatory scrutiny. The FHLBB's response was to lower the net worth requirements from five percent of liabilities prior to 1980 to three percent by 1982. Because many thrifts were unable to meet even the three percent requirement the FHLBB, acting under provisions of the Garn-St. Germain Act, began to issue net worth certificates to thrifts. Under this program, thrifts were issued promissory notes from the FSLIC in exchange for "net worth certificates" from the thrift. The thrift was allowed to count the promissory note as an asset and the net worth certificate as part of its net worth (essentially stock). This practice, criticized by the AICPA, artificially increased the net worth of insolvent thrifts, often above the three percent requirement.

Changes in accounting rules also allowed insolvent thrifts to continue in operation. Generally Accepted Accounting Principles (GAAP) were modified to become Regulatory Accounting Principles (RAP). Under RAP accounting, a thrift was able to sell-off loans at a loss and defer the loss for a period of ten years (White, 1991). Previously under GAAP, losses were recognized immediately. Because of this change in accounting principles, thrifts were able to sell the loans at a loss and reinvest the proceeds in newly established markets (commercial real estate, consumer loans, ARMs, etc.) while enjoying the
benefits of the loss deferrals.

As regulations were relaxed in the 1980’s and thrifts began to operate in new markets, thrift management was forced to assess risk in areas in which they had little knowledge. Some weakened thrifts chose a conservative strategy and continued to invest largely in mortgage-backed securities. These thrifts believed that interest rates would return to previous levels and they would return to solvency.

Other thrifts chose a more aggressive course. Because of the relaxed regulations, these thrifts chose to try and work themselves out of insolvency by choosing high-risk, high-return investments. Investments in risky projects such as acquisition, development, and construction loans became popular, as did investments in high-yield, high-risk bonds. Because deposits were now insured up to $100,000, thrifts were eventually able to attract more deposits and invest in these high-risk projects (Scott, 1990).

The increase in deposit insurance also led to an increase in brokered deposits. Brokers could place investors’ monies with the thrift that was offering the highest CD rate and the investor would be exposed to no risk. If the thrift failed, the broker would recoup its money from the deposit insurance fund because each $100,000 bundle placed with the S&L had an individual investor’s name on it. When brokered deposits began to slowly increase, money became available for thrift management to increase investment in risky areas.
As thrifts began to diversify their portfolios, the FHLBB, the agency in charge of regulating the industry, underwent change as well. Due to government cutbacks, the number of thrift examiners was reduced as was the number of thrift examinations that took place. At the same time the district office in charge of the Southwest was moved from Little Rock to Dallas. While this move seemed harmless at the time, it did cause much disruption because very few supervisors made the move. The office was forced to restaff itself which necessitated a reduction in the number of thrift examinations that could take place in its district (Arkansas, Louisiana, Mississippi, New Mexico, and Texas) (White, 1991).

The thrift industry underwent rapid growth during 1983 and 1984. Arkansas, whose FSLIC-insured thrifts saw an asset growth rate of -2.3% in 1982, rebounded to post asset growth rates of 42.9% and 24.7% in 1983 and 1984, respectively. Many thrifts grew by as much as four hundred percent during this time period. Diversified American Savings Bank of Lodi, California is one such example. It grew from $11 million in assets in 1982 to $978 million in 1985. The quality of the growth, however, was suspect. With the opportunity of investing in new markets, many thrifts grew by investing in "non-traditional assets". Between 1982 and 1985, non-traditional assets held by thrifts nearly tripled (White, 1991). Relaxed regulation could account for some growth but factors such as the economy also contributed to the phenomenal growth of this period.
The economy began to rebound in the early 1980's. In 1981, the Economic Recovery Tax Act was passed. Under this act, depreciation periods for commercial real estate investments were shortened. This action made real estate investing much more profitable and thrifts engaged in the financing of a large percentage of these investments. The economy in the Southwest also benefited from an increase in the price of oil. Oil prices reached a peak in 1981 at $34 per barrel and experts predicted an increase in the range of $80-100 per barrel in the future. Higher oil prices led many thrifts to invest in real estate development projects in the Southwest even though these investments were heavily dependent on the projected increase in oil prices, thus very risky (White, 1991). Asset growth continued at a record pace through 1984.

Several events occurred in 1984 that brought the rapid growth of savings and loans to a halt. A proposal, offered by the Department of the Treasury, encouraged an overhaul of the tax code. Under the proposal, previously-short depreciation periods would be lengthened. This change would contribute to a sharp decline in real estate values. The proposal was argued over the next two years and in 1986 it became the Tax Reform Act.

In addition to the decline in real estate values caused by the Tax Reform Act, oil prices did not continue to increase the way that the experts had predicted. After 1981 oil prices began a steady decline reaching their lowest point of less than $10 per barrel in 1986. The steady decline in oil prices precipitated a
further decline in the value of real estate projects that had been undertaken in anticipation of high oil prices. Loan defaults were now inevitable. Thrifts, whose phenomenal growth was due to their high-risk investments, were once again in great danger of insolvency. Events that took place between 1981 and 1986 only served to exacerbate their problems.

In 1986 the extent of the savings and loan crisis started to become apparent. Although most of the institutions became insolvent during a period from 1983 through 1985, these insolvencies were not recognized until 1986. This discrepancy was due to the "creative" accounting methods available under GAAP and RAP. For example, under GAAP a thrift could make a loan to a borrower and charge large up-front fees. To compensate the borrower for the fees the thrift would charge a below-market interest rate on the loan. The thrift would be allowed to recognize the income from the fees immediately, thus boosting income, while recording the loan as an asset at its face value (White, 1991). RAP accounting exacerbated the problem through its liberal policies, like the deferral of loan losses.

Failures occurred largely among those thrifts that undertook an aggressive approach to improving net worth. Those institutions that chose to follow a more conservative approach were largely restored to solvency following the recession of 1981–82 because they had elected to invest in less risky, traditional investments. States such as Texas, where most thrifts had invested in high-return real estate projects, were
hardest hit by the crisis. In 1987, 109 of the 279 FSLIC-insured thrifts in Texas were considered insolvent under the lower RAP requirements (White, 1991). As thrifts in Texas became insolvent, consumers became scared. Many depositors, fearing the insolvency of their own thrift, began to withdraw their funds. In an effort to keep their depositors, Texas thrifts were forced to pay a "Texas premium" on deposits. This premium was often a half-point higher than the interest rates paid outside of Texas. This action alone increased the operating expenses of Texas thrifts often to the point of insolvency (White, 1991). By 1988 government plans to dispose of insolvent thrifts were well under way.

In 1988 the FSLIC disposed of 205 insolvent thrifts, up from 47 thrifts a year earlier (White, 1991). The FSLIC preferred to place an insolvent thrift with an acquirer because it often was cheaper and easier than holding the assets and subsequently selling them off in piecemeal transactions. Insolvent thrifts were placed on the auction block and bids were accepted from those who met the qualifying standards. The only cost to the FSLIC would be to replace the gap between the value of the assets and liabilities. In many cases intangibles, like goodwill, were used to partially fill this gap. For example, if an insolvent thrift consisted of $10 million in liabilities and assets valued at $2 million, the FSLIC would be asked to supply $8 million in cash to fill the gap. In many cases, however, the FSLIC argued that the thrift had going-concern value, and would create a
goodwill asset which the acquirer would accept in lieu of cash, thereby reducing the cost to the insurance fund.

Many thrifts, however, were so badly in debt that they were forced into liquidation, a process that quickly depleted the reserves available from the FSLIC. The process of liquidation often took several years because of the difficulty in selling off individual parts of the insolvent thrift. Every day that an insolvent thrift was held for disposal increased its cost to the FSLIC because of the need to hire government employees to oversee the disposal.

As the Bush administration took office in 1989, steps were taken to bring the crisis under control. Even though 205 institutions were disposed of in 1988, 243 remained RAP-insolvent at year-end and twice that were insolvent based on tangible net worth. Tangible net worth was seen as a better measure of solvency because it excluded the goodwill account from its calculation. On August 9, 1989, President Bush signed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), designed to fund the disposal of insolvent thrifts and to keep the crisis from happening again.

Under FIRREA new agencies were established and the FHLBB was restructured. The Resolution Trust Corp. was established to act as conservator/receiver for failed thrifts. The FHLBB was replaced by the Office of Thrift Supervision which would operate under control of the Department of the Treasury (Molloy & Primoff, 1989). Federal Home Loan Banks continued to function in
each region to loan funds to the thrifts. FIRREA made available an additional $50 billion for disposal and distribution of insolvent thrifts.

In order to raise the funds needed for the recovery of the industry, insurance premiums were increased for the surviving thrifts and the insurance was to be handled by the FDIC, the insurer of commercial banks. Premiums would be as high as $0.23 per $100 of deposits through 1993 and would then level off to $0.15 by 1998. Estimates of the eventual costs to complete the disposal of insolvent institutions have been as high as $500 billion. For this reason, FIRREA included provisions aimed at keeping the crisis from happening again.

FIRREA attempted to re-regulate the savings and loan industry in many ways. The qualified thrift lender test would require thrifts to devote seventy percent of their assets to housing-related investments if they were to obtain low-interest advances from their respective Federal Home Loan Banks. The previous test required the thrift to devote only sixty percent to housing-related assets. Standards were also established to increase the then low net worth requirements, gradually returning them to a level comparable to commercial banks. RAP accounting standards were also expected to change. Many expected that new standards would more closely conform to GAAP and may become more stringent than those required for commercial banks.

FIRREA, a document containing over 700 pages, enacted many changes in the thrift industry. A final provision of FIRREA,
however, would prove to affect the savings and loan industry, as well as other industries, for years to come. Under FIRREA, the Office of Thrift Supervision was given the task of pursuing and collecting penalties from those who it felt contributed to the collapse of the savings and loan institutions. The difficult task facing the OTS was that of deciding who deserved to pay for the crisis and then to pursue legal action to recover damages from these contributors. It is this provision of FIRREA that has gained much publicity in the last few years as the OTS began to pursue everyone who they could associate with the crisis, specifically targeting those who had the resources to pay.

CONTRIBUTORS

Blame for the S&L crisis cannot be placed with one individual or group. Because the crisis was so very complex, one must examine those who contributed to the crisis and the role that each played. Those who are thought to have played a significant role include: thrift management, the FHLBB, Congress, the accounting profession, and the independent auditors.

Many consider the management of S&Ls as a major contributor to the crisis of the 1980's. Charles Keating and others are cited as prime examples of what went wrong and who is to blame. Studies, however, indicate that insider abuse accounted for only a small percentage of those thrifts that failed compared to the percentage that failed due to poor management. Many who have analyzed the crisis believe that it was primarily the incompetent
management after deregulation that accounted for the problems of the failed S&Ls.

The percentage of failed banks that exhibited signs of major weaknesses in managerial quality approximated ninety percent while banks that also exhibited signs of insider abuse approximated only thirty-five percent (Compton, Lathan, Kemp, 1991). After deregulation, thrift managers were asked to assess risk in areas in which they had little experience. This lack of experience in new areas is thought to have contributed to the failures of many thrifts because management was too quick to invest in high risk areas. The public, however, is often led to believe that fraudulent activities alone were to blame for the subsequent crisis. Many thrift managers, however, either did not have the knowledge to adapt to the new environment of the savings and loan industry after deregulation or used their positions as managers recklessly. For example, many thrift managers used thrift funds to spend lavishly on salaries, personal entertainment, and new corporate headquarters. While poor management appears to be a major factor in failed thrifts, the fraudulent activities of men like Charles Keating cannot be ignored.

Charles Keating, chairman of the failed Lincoln Savings and Loan, is perhaps the most recognizable player in the S&L Crisis. After deregulation, Keating engaged in highly speculative transactions and deception. American Continental, the parent company of Lincoln Savings, was able to sell to 23,000 investors
$200 million in high-risk, high-yield bonds, or "junk bonds". These bonds were usually sold at the many branches of Lincoln Savings, leading many investors to falsely believe that they were insured against loss. Soon after this sale the bonds became worthless when it was discovered that American Continental had engaged in a number of questionable real estate transactions and unfair business practices (Brooks, 1990). American Continental declared bankruptcy on April 13, 1988. The following day Lincoln Savings and Loan was placed in the care of government regulators. Losses at the failed institution were expected to exceed $2 billion, the largest thrift failure to occur at that time (Nash, 1989). Keating’s deception involving the high-risk bonds and real estate ventures were largely to blame for the failure. In April of 1992, Charles Keating was found guilty of securities fraud and sentenced to ten years in prison. Numerous other charges are still pending against Mr. Keating.

Deregulation provided thrifts with the opportunity to improve their financial situations through many new markets. Managers whose thrifts were already nearly insolvent saw deregulation as a great opportunity. Many, however, did not appropriately assess the risks associated with these new areas. Management’s judgment was often used as the sole determinant of loan collectibility in such risky areas as ADC (acquisition, development, and construction) and other commercial loans (Molloy & Primoff, 1989). Deregulation’s intent was to allow faltering thrifts to improve their financial position. Statistics proved,
however, that as a result of deregulation thrifts were growing at a dangerously rapid rate. Rapid growth would be acceptable if it was accompanied by conservatism and caution but the growth that followed deregulation was too risky. It became the job of the Federal Home Loan Bank Board to ensure that the industry survived in the new environment. A job that many believe the FHLBB failed at miserably.

The FHLBB was established as the regulator and promoter of the S&L industry. It is believed that this dual role as regulator and promoter played an important role in the escalation of the failures. As regulator the FHLBB was responsible for ensuring that the industry was economically stable. The FHLBB was given the task of examining existing thrifts and closing those that did not meet government standards. As promoter the FHLBB was responsible for reassuring the public and Congress that the industry was financially stable. This dual role is thought to have forced the FHLBB to allow capital standards to be lowered so that it could report to the public that the S&L industry was a good place to invest their money (Molloy & Primoff, 1989).

In addition to its lowering of the capital requirement standards, the FHLBB is thought to have contributed to the crisis through its development of the RAP accounting principles. Under RAP thrifts were allowed to artificially inflate their earnings. This was done primarily through the use of deferred loan losses. Under RAP, thrifts were allowed to sell assets at a loss and then amortize the losses for a period of ten years. Over the ten-year
period, thrifts were allowed to carry the unamortized portion of
the loss as an asset thus inflating the balance sheet.
Another questionable accounting practice allowed by the FHLBB was
the creation of supervisory goodwill. When the number of
insolvent thrifts became high, the FHLBB encouraged the purchase
of these insolvent thrifts by solvent thrifts. When solvent
thrifts purchased the assets and liabilities of an insolvent
thrift they were often convinced by the FSLIC to create a
goodwill asset to partially fill the gap between the thrifts
inadequate assets and its liabilities, thus lowering the cost to
the FSLIC. This goodwill asset often had no real or measurable
value which led to an inflated balance sheet for the acquiring
thrift.

Other actions by the FHLBB included the issuance of
basically worthless net worth certificates (discussed previously)
and the reduced number of thrift examinations that occurred at
the height of the crisis. As discussed previously the FHLBB
underwent many changes during the Reagan administration. Among
them was the reduction of the number and an increase in the
responsibilities of thrift examiners. Bank examiners, who were
previously trained to examine long-term home mortgages, were now
expected to analyze the complex transactions like those found in
the ADC loan and commercial loan environments. The reduction in
staff coupled with a lack of training allowed many insolvent
thrifts to escape regulatory scrutiny. The FHLBB contributed to
the crisis in many ways, but many of its actions were
precipitated by actions taken by the Congress and the executive branch.

In response to the problems of the S&L crisis, Congress enacted legislation aimed at improving the S&L situation. Among these acts were the Depository Institutions Deregulation and Monetary Control Act of 1980, the Garn-St. Germain Act of 1982, the Competitive Equality Banking Act of 1987 (CEBA), and the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). Critics have argued that Congress reacted too slowly to signs of an impending crisis due to a very strong S&L lobby.

Others argue that the legislation was not only slow in being passed but also flawed in its logic. These critics believe that due to the flawed logic these acts only served to exacerbate the problem. For example, after brokered deposits became popular the Bank Board attempted to discourage the deposits by limiting the deposits to $100,000 per broker, an action that was later deemed illegal by federal courts (White, 1991). The flawed logic in this action by the Bank Board stems from the fact that the growth of deposits was not the problem facing thrifts. The problem existed when the thrift invested these deposits in high-risk areas. An appropriate remedy would have been to restrict the thrift’s investments not to restrict the thrift’s ability to attract funds. In addition to the various enactments of Congress aimed at improving the environment for S&Ls, many place blame with the legislative and executive branches because of the damage
done by the Tax Reform Act of 1986 and the failure of these branches to support the work of the FHLBB.

During the early 1980's the presidential administrations of Carter and Reagan decided that the thrift industry's problems were caused by the limited asset and liability powers open to them. They believed that the industry would survive only if it were allowed to expand into markets previously monopolized by the commercial banks. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) became the result of this belief.

Deregulation of the S&L industry followed the deregulation of many other industries. The trucking, airlines, and railroad industry were already or soon would be deregulated and the government believed that deregulation of the S&L industry would be the best answer to the continuing problems of the S&L industry (White, 1991). Analysts argue that the deregulation of the S&L industry should have been treated much differently than the deregulation of the other industries. The administration believed that once deregulated an industry should become virtually free from government intervention. The airline industry, however, struggled to survive after government intervention. Given the financial disasters that followed the deregulation of other industries one was left to wonder why S&L deregulation was not handled with more care. Critics argued that strict safety and soundness regulations needed to remain in place until the industry proved it could handle the deregulation.

Because economic recovery of the industry remained slow,
Congress responded by enacting the Garn-St. Germain Act of 1982. This act attempted to further expand thrift asset and liability powers and also delegated more authority to the FHLBB to deal with insolvent thrifts. Unfortunately, shortly after delegating authority to the FHLBB the Reagan administration reduced the budget and manpower of the Bank Board which forced them to overlook many insolvent thrifts. With the expansion of asset powers, thrifts began to grow at phenomenal rates by plunging into new markets. Many in Congress mistakenly believed that this growth signaled the end of the crisis and again began to ignore the S&L industry.

In 1987 Congress decided that deregulating the savings and loans was causing more problems than it was solving because thrifts were engaging in high-risk transactions. Congress' response was the enactment of the Competitive Equality Banking Act. Under CEBA the qualified thrift lender test, which first appeared in the Garn-St. Germain Act of 1982, was strengthened. The QTL test required thrifts to maintain a certain percentage of tangible assets (all assets excluding assets like goodwill) in "qualified thrift investments". This action was an attempt to return the industry to home mortgage lending. Critics maintain that this action was detrimental to the industry in that it was returning S&Ls to lending markets that had already proven to be unprofitable ("buying short, lending long"). Rather, thrifts should have been allowed to continue commercial lending because the short-term nature of these loans helped to prevent the risk
of the "interest-rate squeeze" inherent in home mortgage lending.

As the monetary cost of the crisis continued to escalate Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989. FIRREA formally recognized that swift action was needed to stem the tide of thrift failures. Agencies were established to oversee the bailout, capital requirements for thrifts were raised, and existing accounting standards were addressed. Many of the provisions of FIRREA were expected to help the industry but FIRREA also aimed to return the thrifts to home mortgage lending, an action criticized because it again attempted to return the industry to a structure that had already proven troublesome when interest rates increased.

The Tax Reform Act of 1986 was the final blow levied by Congress to an already unstable thrift industry. In 1981 the Economic Tax Recovery Act made real estate investments profitable by shortening the periods for depreciation. Shortened depreciation periods and the anticipation of high oil prices led thrifts to invest in commercial real estate projects. However, in 1986 when the Tax Reform Act was passed depreciation periods were lengthened. The lengthening of depreciation periods coupled with the decline in oil prices sent real estate values plummeting (White, 1991). Loan defaults became common because many thrifts who had invested in ADC loans were finding that the projects were either being abandoned or the finished buildings were standing empty, making payment by the borrower nearly impossible. The previously stable thrifts were soon experiencing insolvency.
Congress, after passing the FIRREA legislation, was given the task of finding the funds necessary for allocation to the Resolution Trust Corp. and the Office of Thrift Supervision. Knowing that prosecutions of those thrift managers who engaged in fraud would bring very little money, the Office of Thrift Supervision concentrated its efforts toward those who it felt could afford to pay. Specifically, the independent auditors.

In the effort to collect the necessary funds for the S&L crisis few of the large public accounting firms have been spared. One needs only to open a newspaper to discover the extent of the litigation now facing public accountants. The auditors of the failed thrifts are generally blamed for failing to disclose regulatory violations or internal control weaknesses. Incomplete or inadequate evidence in the working papers is also an area of blame. Many firms were accused of failing to secure independent verification of real estate appraisals and relied solely on management's assertions of the real estate values (Molloy & Primoff, 1989). Public accountants have also been accused of underpricing their services in an effort to attract clients. Critics contend that due to the lower fees clients received inadequate audit services because the firms could not afford to allocate the required resources. Public accounting firms, for the most part, are defending themselves against what they believe to be unfair attacks. Many believe that the efforts of the OTS are simply an attempt to collect money for the thrift cleanup and have little to do with who is actually at fault.
In 1989, the General Accounting Office issued a report on the quality of the audits performed on savings and loans. The report contained criticisms of areas of the audit that were considered deficient. The GAO report claimed that auditors did not assess the risk involved in restructured and past due loans. Many auditors, the GAO claimed, made inadequate reviews of appraisals and often failed to obtain verification of appraisal values. Other criticisms included a failure to report internal control weaknesses and a lack of communication between bank regulators and independent auditors. Many of these criticisms became the basis for the litigation that was to follow.

In December 1988 Silverado Banking Savings and Loan Association failed. The failure of Silverado is expected to cost well in excess of one billion dollars. Before deregulation Silverado claimed a modest $75 million in assets. By 1988 Silverado's assets numbered more than $2 billion. Much of this increase was due to heavy investments in high-risk commercial real estate (Purdy, 1990). Coopers & Lybrand, the accounting firm responsible for auditing the statements of Silverado, was charged with failure to alert regulators to problems at Silverado. This charge, however, suggests that the auditors have a duty to report irregularities to the regulators when, based on GAAS standards, they do not. As a result of this litigation the courts ordered Coopers & Lybrand to pay $20 million to the FDIC in July 1991 and $250,000 to the Colorado Board of Accounts in July 1992. Coopers & Lybrand has continued to deny allegations...

Arthur Andersen & Company, one of the nation's largest public accounting firms, has also suffered as a result of the litigation surrounding the S&L crisis. Andersen served as the auditor of the failed Ben Franklin Savings Association. The Resolution Trust Corp. claims that Andersen failed to assess the true extent of the institution's problems and went along with management's manipulation of GAAP standards to hide its true financial condition. Arthur Andersen has responded to the charges by stating that its services were not to blame for the Franklin collapse. Instead, Andersen points to the collapse of oil prices and economic conditions in the Southwest at the time of the S&L collapse. Arthur Andersen did issue caveats to the audit reports from 1986 and 1987 addressing the increased risks in Franklin's real estate investments due to the economic conditions in Texas at the time. In 1988 Andersen declined to give an opinion on Franklin's statements (Thomas, 1992). The $400 million lawsuit against Arthur Andersen is still pending.

Perhaps the most famous case of the failed savings and loans is that of Lincoln Savings and Loan and its director Charles Keating. Keating and other directors of American Continental, the parent company of Lincoln, were accused of engaging in phony real estate transactions and other unfair business practices. The result of Keating's actions was a $250 million loss to thousands of investors in American Continental bonds. A suit was filed against the auditors of Lincoln, the accounting firm of
Ernst & Young, charging that the firm failed to comply with professional standards.

More specifically, Jack Atchison, the Arthur Young partner in charge of the audit, was accused of failing to exercise auditor independence by continually defending Lincoln's accounting practices and the actions of Charles Keating to Congress and federal regulators. Financial statements prepared by Arthur Young (now Ernst & Young) in 1987 indicated American had operating income of $27 million while the company actually lost $30 to $50 million, largely due to recognized profits that were the result of misleading land and related party transactions (Brooks, 1990). Ernst & Young reportedly agreed to pay $41 million to the Resolution Trust Corp. as a result of the litigation (Knight, 1991). The firm maintains, however, that its work complied with all standards and that payment to the RTC was an effort to avoid the even higher cost of litigation.

Other litigation has involved the accounting firms of Deloitte & Touche, KPMG Peat Marwick, and Grant Thornton, among others. Many firms have agreed to settle their cases out of court in order to avoid the cost of litigation. Recently, however, accounting firms have vowed to fight what they consider to be unwarranted attacks by the RTC. Some analysts have argued that the accounting firms deserve the criticism they have received but agree that much of the problem lies in the standards developed by the accounting profession.

The American Institute of Certified Public Accountants is
responsible for the production of the audit and accounting guide for savings and loan associations. The savings and loan associations' guide in effect for the crucial period from 1980 to 1989 was last revised in 1979, prior to deregulation of the industry. Critics maintain that auditors were unable to understand and evaluate the many changes in the S&L industry and that industry updates were often very late in being issued. Many new markets available after deregulation were not addressed in the audit guide and were late in being addressed by the updates. These areas included high-risk ADC loans and commercial real estate ventures.

Others criticize the AICPA for failing to encourage action by the Financial Accounting Standards Board in response to demands for a better accounting framework for S&Ls. Many would have liked to see the profession move to a mark-to-market system. Under this system it is felt that S&Ls would have had to have been more careful in their analysis of real estate loans. Mark-to-market would have forced the assets of the institution to be evaluated on a timely basis and, as a result, the financial statements would more accurately reflect the financial standing of the institution. Failure to mark-to-market, many argue, has cost the RTC billions of dollars in failed thrifts. Had the thrifts been following mark-to-market accounting, they would not have been able to cover up their financial situation through the creative accounting system available under GAAP and RAP. The banking industry and many accountants agree, however, that the
mark-to-market system, as currently proposed, would be far too costly and very difficult to implement.

As illustrated, many have been blamed for the S&L crisis but no one group has been damaged as much as the accounting profession and the independent auditors. The litigation against the auditors has led many to question the stability of the Big Six accounting firms because financial claims against the firms are often well in excess of the firms’ insurance coverage. Insurance premiums for firms that audit banks has skyrocketed, leading many firms to abandon the audits of financial institutions. The auditors claim that litigation against them is largely unwarranted and they are simply the victims because the government believes that the accountants are the only contributors to the crisis who have the ability to pay. When lawsuits first began to be filed against the accounting firms many felt that it would be less costly to settle the case whether they were guilty or not. Recently accountants have vowed to defend themselves against what they believe to be wrongful attacks.

ACCOUNTANTS' DEFENSE

The accounting profession has been blamed for failing to sound the alarms when the S&L industry seemed to be in trouble. In testimony before the House Committee on Banking, Finance and Urban Affairs, AICPA president Philip Chenok explained that the profession did attempt to warn the government and that those
warnings went unheeded. Chenok cited several examples of
warnings by the AICPA:

*In 1981 when the FHLBB allowed S&Ls to defer losses from
sale of below-market assets, the AICPA warned that this
treatment was inconsistent with generally accepted
accounting principles.

*The AICPA and the FASB objected strongly to the inclusion
of net worth certificates and appraised equity capital in
net worth.

Chenok also noted that the AICPA responded quickly to the
recommendations set forth in the GAO report on S&L audit quality.
These recommendations included the revision of the S&L audit
guide and the requirement to inform AICPA members of the GAO
report (Journal of Accountancy, April 1989). The GAO report was
included in the March 1989 issue of the Journal of Accountancy
and the revision of the audit guide was completed in 1990.

During the course of the hearings, several members of
Congress and representatives of public accounting firms came to
the defense of the accountants. Congressman John LaFalce noted
that the deficiencies of the auditors' "pale in comparison" to
other factors in the S&L crisis. Congressman Bill McCollum
maintained that "accountants are not guarantors" and "It's unfair
to place the major blame on auditors" given the many reasons for
the failures. William Gladstone, former chairman of Arthur
Young, claimed that his firm "did its work in a professional way,
made judgments at the time and gave opinions that, with the facts
known three and four years ago, were reasonable" (Journal of Accountancy, April 1989).

The GAO report on the deficiencies of the S&L audits has drawn much criticism. Auditors studied in the report were accused of failure to determine compliance with rules relating to loans to affiliates, excessive concentrations of loans in geographic limits and to single borrowers. Earlier in the same report, however, reference is made to the fact that the compliance to these rules is to be determined by the regulators, not the independent auditors. Accounting firms have argued that many deficiencies cited by the GAO were not their responsibility but were the responsibility of the regulators. This argument, they feel, is continually being ignored in an effort to collect from the so-called "deep pockets".

The GAO report indicates that many audit procedures were lacking and continues by encouraging the AICPA to address these issues in a new audit guide. Critics argue that auditors should not be accused of negligence if the standards are not even addressed under the S&L audit guide. Auditors, they argue, were simply complying with existing generally accepted auditing standards (Goldwasser, 1990). Courts, however, have continually held the auditor to even higher standards than those legislated by the Auditing Standards Board.

Another deficiency found by the GAO is the failure of the auditor to report internal control weaknesses to regulatory authorities. The auditing literature effective through March
1988 did not require the reporting of internal control weaknesses to regulatory authorities. If the audit uncovers weaknesses in internal control, the auditor is responsible for reporting these weaknesses to the client's management. It is then the obligation of the S&L, not the auditors, to forward internal control reports to the FHLBB, now the OTS (Goldwasser, 1990).

Many feel that the litigation now facing the public accountant stems from an expectations gap between what the auditor actually does in an audit and what the public believes an auditor does in an audit. The objective of an audit is to provide "reasonable assurance" that the financial statements are free from "material misstatements." It is unreasonable to ask the auditor to check every transaction of its client; therefore, samples are obtained and checked to assess the reasonableness of the financial statements.

Many in the public misconstrue the work of auditors. "There is a longstanding belief that auditors render a 'Good Housekeeping' seal. We do not. We do not say this is a great investment to make," says J. Michael Cook, chairman of Deloitte & Touche (Jacob, 1991). Given the perception that auditors do render a 'Good Housekeeping' seal, it is easy to see why accountants might be blamed for failures that often occurred less than one year after an unqualified audit opinion was rendered.

One defense available to the auditor stems from the fact that the audited financial statements are representations of past events. How, auditors argue, could they be expected to prevent
the losses attributable to the S&L crisis given that the events had already taken place? For example, in the GAO report on S&L audit quality the auditors were blamed for failure to adequately review "problem loans". However, if these loans were already considered problems, what more could the auditor have done to prevent the losses that followed (Goldwasser, 1990)? The auditor could have forced management to adjust allowance accounts and recognize losses but the losses would still have occurred even if corrective action was taken precipitously.

Many lawyers assert that the auditors should be allowed to defend themselves in court by claiming that governmental agencies overseeing the S&Ls failed to inform the auditors of their own findings. Lawyers contend that the accountants should be able to assert certain affirmative defenses in order to limit the liability attributable only to the auditors' negligence. These defenses should include contributory or comparative negligence, the doctrine of unclean hands, and a failure to mitigate damages. Accountants, in asserting the above charges, must prove that the federal government owes a duty of care to the accountants. Auditors, when assessing risk for an engagement, rely on many factors present in the industry under audit. In the case of a financial institution, the auditor has come to rely upon the federal regulator as a source of industry information that could be relied upon as accurate and unbiased. Congress, in the FIRREA legislation of 1989, mandated that all financial institutions furnish their most recent state or federal examination reports to
the independent auditor. This action suggests that auditors should be able to rely on this information as being fair and accurate, thus creating a duty of care on the part of the regulators. In the past, the FDIC has successfully defended itself against those who charge the FDIC with failure to exercise a duty of care. The FDIC maintains that its only duty is to the public, or the insurance fund. It has successfully maintained that it owes no duty to the auditors to detect and communicate illegal or unsafe and unsound practices. Consequently, any FDIC negligence has always been found to have no bearing on auditor negligence. Lawyers and accountants agree that faced with the current wave of litigation and potential bankruptcy of major accounting firms, courts should reconsider the FDIC's and other governmental agencies' duty of care (Leibell, 1991).

Accountants have also faced problems when they discover discrepancies in the books of their client. When an accountant discovers that misstatements exist they are required to report these findings to management or the client's audit committee. If the client refuses to modify its assertions, the auditor would then issue an adverse report or resign from the client. Upon resignation, the S&L would then "shop" for an auditor that would agree with its methods. Accountants maintain that resignation from a client has offered little protection from future litigation, citing recent cases involving Arthur Andersen and others.

Accountants believe the long list of litigation that has
resulted from the S&L crisis is the product of an outdated legal system. Under the joint and several liability doctrine each defendant is fully liable for all damages regardless of his degree of fault. In addition, existing law makes no provision for a recovery of legal costs in frivolous cases brought before the court. It is these two factors, accountants argue, that have contributed to the abundance of lawsuits against the auditors.

Unfortunately, accounting firms, faced with the prospect of high legal costs, are often forced to settle out of court. In 1991, the cost to defend and settle lawsuits for the Big Six accounting firms was in excess of $477 million (Liability Crisis..., 1992). The financial liability of the accountants involved in litigation over the S&L crisis is expected to exceed $9 billion, excluding compensatory damages (McCarroll, 1992). By settling claims out of court the accounting firms save money, but their reputation is often damaged. In the public eye, out of court settlements are perceived as admissions of guilt. Big Six accountants fear that the financial impact, as well as, the damage to the image of the accounting profession because of the increased litigation will have far-reaching consequences if it is allowed to continue.

On August 6, 1992 the chief executives of the Big Six accounting firms issued a statement of position concerning the liability crisis facing the accounting profession. In the paper, the executives outlined the consequences of continued litigation against the accounting firms. One effect was referred to as "the
tort tax". The tort tax is the result of the increased cost of goods and services as a result of the increasing litigation. The fee for audits will rise substantially due to litigation; as will the services of other professionals now facing a litigation crisis (eg. lawyers). These executives believe that the increase in costs of services will eventually lead to American businesses being placed at a competitive disadvantage because most other countries do not currently contend with a liability system like the one in place in the United States.

Another result of the outbreak of litigation will be the reduction in quality audit services. Currently many firms are refusing to perform audits in industries that present a high risk to the auditor. Industries like the financial institutions, insurance, and real estate may find themselves without auditors. Without quality auditors in these key industries the United States will again find itself having difficulty competing because quality auditors often provide management with methods of becoming more efficient and cost-conscious.

The final fear expressed in the statement involves the recruitment and retention of employees for the accounting firms. According to the Atlantic Monthly magazine fewer top business students are choosing to work in the audit department of a public accounting firm because they perceive it as too risky. This phenomenon is expected to worsen given the escalation of lawsuits and media coverage regarding the role of public accounting in the S&L crisis (Liability Crisis..., 1992).
FUTURE

The United States will continue to pay for the S&L crisis for years to come. The trend of the late 80’s and early 90’s was to punish those who were able to pay. The government seemed to feel that this was the best way to avoid making the public pay for the crisis. On the surface, one would think that the lawsuits initiated by the RTC were indeed saving the taxpayers money. The effect of the lawsuits on big business, however, indicates that the taxpayers will not save money in the long-run.

As expressed by the Big Six accounting firms in their joint statement on the liability crisis, the rising costs of liability will have to be passed on to their clients in the form of fee increases if firms are to survive the recent wave of litigation. For large, established companies this, of course, means a decrease in profits or an increase in their own prices, which would then be passed on to the average consumer. For start-up companies wishing to go public the impact is even more profound. Many start-up companies might, in the future, be unable to obtain audits because they will be unable to afford them or because the auditors will not want to take on the risk. As a result, job growth and economic growth will continue to suffer (Smith, 1992).

The very survival of the S&L industry is also at issue given the recent wave of litigation against their auditors. Many accounting firms are now refusing to consider an S&L audit because of the costs associated with it. Many insurance
providers are charging exorbitant premiums for any firm engaging in an S&L audit. Critics believe that a time is coming when an S&L will be either unable to secure an auditor or the auditor it is able to obtain will lack the expertise to perform a quality audit. One can see that if the trend toward litigation continues to flourish, the cost to the average taxpayer could be very great because these thrifts will no longer exist to provide jobs and encourage investment in the community.

In response to this crisis, big business has formed the Coalition to Eliminate Abusive Securities Suits, the CEASS. This coalition consists of the major US accounting firms and major US companies like Merrill Lynch and Morgan Stanley. The purpose of the coalition is to "put a stop to unwarranted securities fraud suits that disrupt business operations and drain a firm's capital and managerial resources". CEASS is pushing for reform which would include a system of proportionate liability and a call for losing litigants to pay the fees of the winner. (Smith, 1992).

The future of the S&L industry remains uncertain as failures continue and many thrifts are becoming banks to escape the high insurance premiums being levied against the surviving thrifts. President Clinton's position on the crisis is still unclear. In an effort to return the industry to stability, Congress has enacted over forty major regulatory provisions since 1987 aimed at banks and thrifts. Bankers warn that these provisions are crippling the ability of financial institutions to meet the credit needs of their communities. They contend that over 40,000
employees now spend all of their time complying with government regulations at an annual cost of $10.7 billion dollars. In 1991, Congress enacted a major piece of banking legislation that is expected to further increase the bankers' costs of compliance. This act, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), will subject the industry to further scrutiny and paperwork. Among the provisions of the act are risk-based insurance premiums, mandated annual audits, full-scale on-site examinations, and new rules on real estate lending. The American Bankers Association complains that these new regulations will further reduce the resources available for consumer lending and financing local economic growth. The banking industry has suffered as a result of the S&L crisis because legislators fear that banks will suffer the same crisis as that suffered by the savings and loans and have enacted much legislation to prevent a similar crisis. Bankers maintain that "no other private industry is so heavily regulated or burdened with such high regulatory compliance costs" (ABA, 1992).

Congressional inaction has also stalled the cleanup of failed thrifts. Since April of 1992, the House of Representatives has continually failed to vote more money for the Resolution Trust Corporation, the agency in charge of disposing of the thrifts. The Treasury Department estimates that each day of delay increases the cost of the cleanup by $6 million. The Congressional Budget Office expects that several hundred more thrift failures will occur through 1995. Albert Casey, head of
the RTC, has requested forty-three billion dollars, stating that this would be his last request for funding the cleanup. As of November 1992, the RTC was being forced to keep seventy insolvent institutions open while it awaited funding for their disposal (Fefer, 1992).

Recent events indicate that lawsuits against the auditors of S&Ls will continue. Ernst & Young, faced with several outstanding lawsuits, agreed to pay $400 million dollars to settle all claims. Under the terms of the agreement, Ernst & Young also agreed to allow the FDIC to file a motion asking the courts to throw out a decision by the Fifth Circuit Court of Appeals regarding claims against Ernst & Young. In this decision the courts ruled that the FDIC could not claim that directors relied on the work of E&Y or that the thrift was harmed by the audit. This decision would have set a precedent that many other accounting firms could have relied on in defense of their respective suits. If the decision is thrown out, claims and rulings in favor of the FDIC are expected to increase (Berton, 1992).

Experts contend that as long as those in Washington continue to ignore the crisis, costs will continue to rise. The government, attempting to recover from the disastrous effects of the deregulation of the thrift industry, has enacted a great amount of legislation aimed at both the banking and thrift industries. The government must realize that deregulation does not work without the proper controls. They must remember,
however, that by imposing so many expensive regulations on the industry they are preventing the banks and thrifts from investing in communities.

Lawsuits will also continue against those able to pay for the crisis as long as Congress fails to approve the funding needed for the cleanup. Reform is needed if the industry is to survive. The Financial Accounting Standards Board, upon encouragement from the SEC, is now examining the feasibility of mark-to-market accounting standards. The banking and thrift industries, however, are vehemently opposed to this practice because of its high cost and difficulty of implementation. Much of the research into mark-to-market is now being concentrated toward finding a system that is both relatively inexpensive and easy to implement.

Those who have suffered most from the crisis are now looking at ways to ensure that it does not happen again. The banking industry, together with the accounting profession and government agencies, should continue to work toward finding a solution that will prevent a crisis like that experienced by the S&Ls from ever happening again.


