

Approved:

Jan 25 1993
Date

MINUTES OF THE HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE.

The meeting was called to order by Chairperson William Bryant at 3:30 p.m. on January 19, 1993, in Room 527-S of the Capitol.

All members were present except:

Committee staff present: William Wolff, Legislative Research Department
Bruce Kinzie, Revisor of Statutes
Nikki Feuerborn, Committee Secretary

Conferees appearing before the committee:

Kevin Glendening, Office State Banking Department
David Douglas, Savings and Loan Department
Bill Caton, Consumer Credit Department
Wayne Warfel, Credit Union Department
Bill Francis, St. Francis Regional Medical Center of Wichita

Kevin Glendening of the Office of the Bank Commissioner reviewed the general responsibilities, mission, structure, examination methods, and bank rating system used by the Office. The 500 banks in Kansas represent \$15 billion dollars in total assets with 75 percent being under the primary jurisdiction of this office. The State Banking Board is appointed by the Governor and the Office is a fee supported agency. (Attachment 1).

David Douglas, Office of the Commissioner of Savings and Loan, described the restructuring, new regulations, and some of the problems of the S&L industry which has caused the number within the state to drop to 32 with the prospect of losing even more of these businesses. The budget for this department is financed through assessments of the S&L's. Banks have taken over 95% of the lost business due to the similarity in their regulations now which have allowed for the merger with federal banks and out of state banks. There is little prospect for the creation of new S&L's within the state. The creation and responsibilities of the Resolution Trust Corporation (RTC) which is managed by the Office of Thrift Supervision was explained as an agency to take over failed savings and loans, and to manage and liquidate them. (Attachment 1A).

Bill Caton of the Office of Consumer Credit reviewed the Kansas Uniform Consumer Credit Code, Kansas Investment Certificate Act, Kansas Investment Certificate Guaranty Fund Act, and the Kansas Fair Credit Reporting Act. This office is not responsible for banks, credit unions or savings and loans but regulates the rates and charges of credit providers. At least four payments on a consumer credit contract are necessary for the contract to come under their jurisdiction. Farms are considered non-consumers so credit for equipment is not under their auspices. The Office also provides continuing education for economics teachers and provides aid to consumers regarding poor credit reports. Their budget is financed from licenses and volume fees (Attachment 2).

Wayne Warfel, Administrator of the Kansas State Department of Credit Unions, stated that the agency is fee supported and the board of directors serve voluntarily without pay. Credit union members are united by a common bond or interest and the largest in the world is in Overland Park. They are regulated by state or federal authority and enjoy positive trends in Kansas. (Attachment 3).

Bill Henry, representing St. Francis Regional Medical Center of Wichita, requested that the Committee introduce legislation which would repeal a "technical" amendment in SB 66 which allowed BC/BS to utilize a procedure called non-assignment in paying health providers and BC/BS insured. This allows BC/BS to make payments to individuals which it insures rather than the hospital which provides the care. Mr. Henry requested that this non-assignment authority held only by Blue Cross/Blue Shield be revoked (Attachment 4).

Representative King moved that the request from St. Francis Regional Medical Center of Wichita be introduced into legislation. Representative Helgeson seconded the motion. Motion carried.

CONTINUATION SHEET

MINUTES OF THE HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE,
Room 527-S Statehouse, at 3:30 p.m. on January 19, 1993.

The meeting was adjourned at 4:25 p.m. by Chairman Bryant.

The next meeting is scheduled for January 20, 1993.

GUEST LIST

COMMITTEE:

DATE: 1-19-93

NAME (PLEASE PRINT)	ADDRESS	COMPANY/ORGANIZATION
Cameron Brewer	Topeka	KTLA
Wayne Palmer	Ozarkie	KSNA
Amy Abbuhl	Lawrence	Intern for Rep. Minor
Alan Steppat	Topeka	Pete Mcbill & Assoc.
Jim Conrick	"	Ks. Press
David Adams	"	Ks. BJC Assoc
Richard Wilborn	McPherson	Ks. Assoc
Suz SNEED	Topeka	Life UNDERWRITER
Joe Furganic	Topeka	Alliance Ins Co
Bill Caton	Topeka	State Farm
Carol Wreggit	Topeka	KCA
Ken Bahr	"	Consumer Credit
George Barber	Topeka	Ks Credit Union Assn
Kathy Sexton	DOB	4th Financial Corp
Chuck Stines	Topeka	KAFS
Kathy Taylor	"	KBA
Jude Stork	✓	"
David Douglass	✓	Ks Bkg Dept
Arlan Holmes	✓	S & L Dept
Wayne Warfel	✓	DOB
		CREDIT
		Ks ST DEPT OF UNIONS

OFFICE OF THE BANK COMMISSIONER (BANKING DEPARTMENT)

DEPARTMENT STRUCTURE

The Office of the Bank Commissioner is commonly referred to as the Banking Department. We are a fee agency, and derive all of our operating funds through assessments on the banks we regulate. The mission of our department is to ensure the safe and sound operation of State Chartered banks and trust companies in Kansas. There are approximately 500 banks in Kansas, 365 of these, or about 75 percent are State Chartered institutions under the primary jurisdiction of our office. Combined, these banks represent approximately \$ 15 billion dollars in total assets.

In fulfilling our oversight responsibilities, we conduct on site examinations of all State Chartered institutions. To carry out this process we have, in addition to our Topeka administrative and support staff of 15, a staff of 57 examiners located in seven separate field offices in Dodge City, Hays, Salina, Wichita, Topeka, Chanute, and Overland Park.

In addition to conducting safety and soundness examinations, our office also regulates and has authority over activities which affect the structure of banking in our state. Branch banking, mergers and acquisitions, and interstate banking are among the most common of these activities.

The State Banking Board serves in an advisory capacity to the Bank Commissioner. The nine members of this board are comprised of six bankers and three individuals who represent the public at-large. The board holds monthly public meetings to discuss branching, interstate, and other pending applications.

*Attachment 1
Financial Institutions &
Insurance
Jan 19, 1993*

The Office of the Bank Commissioner is one of four regulatory agencies which play a part in the supervision of Kansas banks. The other three are federal agencies and include the FDIC (state nonmember), FRB (state member), and OCC (national).

EXAMINATION STRUCTURE

Our department works closely to coordinate examinations with the other regulatory agencies. All of the agencies participate in information sharing and follow the same general examination procedures. Examinations are conducted both independently and jointly with other agencies depending on the circumstances.

The on site portion of examinations last anywhere from two weeks to several months, depending upon the bank or trust company's size and condition. During that time, all aspects of the bank's operation are carefully reviewed. Assessments of the quality of the bank's loan and investment portfolios are made, the strength of its capital position and ability to operate profitably are reviewed, as well as the ability and performance of management and their compliance with laws and regulations.

Each bank is assigned a rating based on our analysis of its overall condition, with 1 being the best and 5 the worst. This rating is referred to as a CAMEL rating, and is used by all regulatory agencies. Banks receiving a camel rating of 3, 4, or 5, are considered problem institutions.

Depending on the nature and severity of a bank's problems, our office may undertake a variety of enforcement actions which could include closing the institution.

2011

There are now 32 savings and loan associations with main offices in Kansas, with total assets of about \$10.4 billion. Fifteen of these are state chartered; seventeen have Federal charters. Two of the Federal associations, Franklin and Overland Park are in receiverships by the Resolution Trust Corporation (RTC). Assets of the fifteen state associations total \$1.6 billion. Total assets are dominated by Capitol Federal with \$3.9 billion. The Savings and Loan Department has no jurisdiction over Federally chartered savings and loan associations.

The ownership of these institutions is about evenly divided between stock companies, which are owned by individual stockholders or holding companies, and mutuals, where the depositors are the owners. While the number and total assets have diminished in the past several years, today's savings and loans associations, aside from the receiverships, are generally well capitalized and profitable.

The problems related to the savings and loan business have been publicized, investigated, discussed, regulated, legislated and litigated ad nauseam. The result is a diminished role in the total national financial community. Individual institutions will continue to make adjustments to recognize changes in the financial community.

Manhattan Federal this month converted from a Federal mutual charter to a National Bank. Columbia Savings has announce an agreement for its sale and merger into Metropolitan Federal Savings, which is headquartered in Fargo, North Dakota. Already, four other out-of-state savings and loan associations have branch offices in Kansas.

The accounts of all savings and loan associations in Kansas, state and Federal, are insured by the Federal Deposit Insurance Corporation (FDIC). State law requires Federal insurance of deposits. The weight of Federal legislation on the savings and loan business has been immense. Overwhelming Federal law and regulation in recent years has reduced the relevance of many state laws. In 1989 the structure of Federal supervision and regulation was overhauled. The Office of Thrift Supervision (OTS) was created to be the primary supervisor of all insured savings and loan associations. OTS is a department of the U. S. Treasury. The Federal Savings and Loan Insurance Corporation was abolished and the FDIC became the insurer.

Attachment 1A Financial Institutions Insurance Jan 19, 1993
The Resolution Trust Corporation (RTC) was created to take over failed savings and loans, to manage and liquidate them.

This task has been largely completed in Kansas. Many of our local savings and loans have disappeared.

Federal law and regulation has virtually eliminated the business differences between state and Federal associations. The Department is funded entirely by semiannual assessments paid by the state chartered associations. As the assessment base has declined the Department has downsized to limit the added expense of a state charter as much as possible. We have three employees, including myself.

All savings and loan associations, both state and Federal, pay an assessment to the OTS based on assets and condition. Problem associations pay a higher rate. All also pay an insurance premium to the FDIC.

In 1990 the OTS and the FDIC each completed its own comprehensive examination of every savings and loan association. Through 1990 the State Savings and Loan Department examined jointly with OTS and a joint state-federal report was prepared for state chartered associations. In 1991 OTS commenced assessing all associations based on assets and it was no longer financially feasible to continue a state examination program. State law allows the Department to accept a Federal examination in place of the state examination. We discontinued state participation in examinations in 1991. We are very familiar with OTS and FDIC examination procedures. They are comprehensive and clearly report the financial condition and operations of Kansas chartered savings and loan associations. In addition, all associations have an annual independent audit and prepare comprehensive monthly financial reports for OTS and the Savings and Loan Department.

The Savings and Loan Department is fulfilling its responsibility to the state. We know the management and condition of each Kansas association. We are sometimes able to add a voice of reason in tangled regulatory affairs. We regularly counsel Kansans who have a concern about a home loan or a financial transaction, often unrelated to a savings and loan.

We will have a further reduction in the number of associations because of business consolidations and conversions to Federal charters. There has been little or no interest from new entrants into the thrift business.

Page 2 of 1A

Having recited this largely gloomy picture I want to praise strongly today's savings and loan associations. They are strong

and providing important services in their communities, often providing services that are not available elsewhere.

It is the Department's objective to allow associations the option to retain their state charters, some 100 years old, as long as it is practical to do so.

OVERVIEW OF THE OFFICE OF THE
CONSUMER CREDIT COMMISSIONER

January 19, 1993

To: The House Committee on Financial Institutions and Insurance

From: Bill Caton, Commissioner

1. Introduction

2. Scope

A. Kansas Uniform Consumer Credit Code

Regulation of credit grantors in State except Banks, S&Ls and Credit Unions - approximately 6,000 licensed and non-licensed lenders. Includes conduct, rates and disclosure.

Education - provides consumer credit education through an annual grant to the Kansas Council of Economic Education (\$70,000 annually)

B. Kansas Investment Certificate Act and Kansas Investment Certificate Guaranty Fund Act

Regulation of consumer loan companies that sell investment certificates to the public to fund their lending operations. Includes conduct, rates, disclosure and safety and soundness.

This industry has collapsed and the last 2 companies are being liquidated under bankruptcy law. Legislative Post Audit Report addresses this situation.

C. Kansas Fair Credit Reporting Act

Oversight of credit reporting agencies operating in State
Provide aid to consumers who have problems with credit reporters.

3. Operation

A. Employees - 7 (4 Office and 3 Examiners)

B. Budget - Annually approximately \$335,000

C. Revenues - Agency is a fee income agency. 25% of all revenues are appropriated to State General Fund

1. Licenses - approximately 20% of revenue

2. Volume Fees - currently \$15 per \$100,000 of outstanding balances - approximately 80% of revenue

4. Conclusions

*Financial Institutions &
Attachment 2 Insurance
Jan. 19, 1993*

**OFFICE OF THE
CONSUMER CREDIT COMMISSIONER
1992 ANNUAL REPORT**

**WM. F. CATON
COMMISSIONER**

**REPORT OF USE OF CONSUMER CREDIT
UNDER THE
KANSAS UNIFORM CONSUMER CREDIT CODE**

- Part I. History of the Consumer Credit Commissioner's Office
- Part II. Consumer Education
- Part III. Creditors Registered with Administrator and Examiners
- Part IV. Number and Nature of Violations and their Disposition
- Part V. Use of Credit in Kansas
- Part VI. Volume of Consumer Credit Extended by Fee Paying Creditors
- Part VII. Problems of People of Small Means in Obtaining Credit
- Part VIII. Extent to Which Rules of the Administrator are in Harmony with Those of Other Code States

Part I. History of the Consumer Credit Commissioner's Office

This agency was created in order to administer the Kansas Consumer Loan Act, K.S.A. 16-401, when it was passed by the 1955 Session to take effect on July 1, 1955.

The department was greatly increased on May 14, 1958, when the Kansas Sales Finance Act, K.S.A. 16-501, was effective. This act covered the installment sale of goods and services including motor vehicles and required the licensing of all sales finance companies.

The department was again expanded in 1961 when the Investment Certificate Act, K.S.A. 16-601, was passed. The commissioner was authorized to issue investment certificate authority to loan companies who accepted investments from the public, and to examine them for solvency. (This industry has collapsed and this responsibility of the Consumer Credit Commissioner will end when the last companies are liquidated through bankruptcy and the act will probably be repealed).

The department was again greatly expanded on July 1, 1969, when the Truth-in-Lending Act, K.S.A. 16-801, became effective which required about 6,000 retail credit grantors file notification and pay notification fees and annual volume fees.

With the exception of the Investment Certificate Act, all the previous laws regulating consumer credit and interest rates were replaced by the terms of K.S.A. 16a-1-101, the Uniform Consumer Credit Code, which was effective January 1, 1974. The Consumer Credit Commissioner was designated as the administrator.

Part II. Consumer Education

An additional responsibility of the Consumer Credit Commissioner is the education of the consumers with respect to credit practices. During 1992, a grant in the amount of \$70,000 was transferred from the consumer credit fee fund to the Kansas Council on Economic Education for this purpose. Subsequently, the Commissioner has taken an active role on the Executive Board and has helped implement programs and instruct classes around the state. The Office of the Consumer Credit Commissioner also distributes brochures and pamphlets to consumers to promote consumer credit education.

Part III. Creditors Registered with Administrator and Examinations Conducted During the Year

A. Registered with the Consumer Credit Commissioner's Office in 1992:

- | | |
|--|-------|
| 1. Licensed Supervised Financial Organizations | 124 |
| 2. Licensed Supervised Lenders | 221 |
| 3. Non-Licensed Creditors (retail credit grantors,
sales finance companies and branch stores) | 5,557 |

B. Examinations Conducted:

- | | |
|--------------------------------|-----|
| 1. Licensed Supervised Lenders | 132 |
| 2. Non-Lender Creditors | 66 |

K.S.A. 16a-2-305(1) states in part, "The administrator shall examine periodically at intervals the administrator deems appropriate the loans, business and records of every licensee except licensees which are supervised financial organizations. The official or agency responsible for the supervision of each supervised financial organization shall examine the loans, business and records of each such organization in the manner and periodically at intervals prescribed by the administrator".

Examinations of licensed supervised lenders are to be made periodically at intervals the administrator deems appropriate. Licensed supervised lenders are examined at least once in a twelve month period. New licensees are usually examined within six months.

Examinations are assigned by a Financial Examiner V. The examiners are not directed to follow any particular sequence of examining, but are to use their own techniques based upon their experience to determine compliance with all the provisions of the code and Regulation Z. This includes checking at least 20% of all open accounts in order to determine the permissibility of finance charges, additional charges, delinquency charges, and deferment charges. In addition, the examiner reviews copies of the disclosure statements given to the debtor to determine whether disclosures have been given in accordance with the law. Paid transactions are examined to determine that debtors received the proper refunds of unearned finance charges and unearned credit insurance premiums.

Upon receipt of a complaint involving a consumer credit transaction, the office investigates the complaint to determine if a violation of the code has occurred. An examiner may be sent to the creditor's place of business to investigate the alleged violation, as well as examine all documents relating to the specific credit transactions. If a violation is disclosed, the creditor is required to make the proper refund, adjustments, or disclosures to satisfy the complaint.

Part IV. Number and Nature of Inquiries and Complaints

A. As a result of complaints and inquiries filed with the Administrator:

<u>Number</u>	<u>Nature</u>
244	Interest & Insurance Overcharges or Refund Errors
127	Lien Release
695	Explanation of Charges, Refunds, Disclosures, Leases, etc.
475	Notification and License
20	Loan Brokers
55	Consumer Education Information
179	Fair Credit Reporting Act
429	Miscellaneous - Non-Code

B. As a result of Examinations Conducted by the Administrator:

<u>Number of Creditors Involved</u>	<u>Number of Individual Cases</u>	<u>Nature</u>	<u>Refunds to Consumers</u>
Consumer Loans:			
62	1059	Interest Overcharges	\$39,507.32
48	254	Insurance Overcharges	15,943.73
<u>49</u>	<u>368</u>	Miscellaneous	<u>38,562.87</u>
159	1681		\$94,013.92
Sales Finance:			
33	178	Interest Overcharges	\$ 5,557.46
1	1	Insurance Overcharges	94.27
<u>3</u>	<u>11</u>	Miscellaneous	<u> </u>
37	190		\$ 5,651.73

Part V. Use of Credit in Kansas

In 1992, additional fees were paid on a total of \$2,071,997,517 which was extended to Kansas consumers by credit grantors.

Part VI. Volume of Consumer Credit Extended by Fee Paying Creditors

Following is a record of the number of registration and notification fees paid under the Uniform Consumer Credit Code during the year ending:

	<u>12-31-91</u>	<u>12-31-92</u>
Registrations:	\$ 3,860	\$ 3,850
Branches:	1,552	1,707
Annual Fees:	81,180	83,355
Number of Volume Fees Paid	416	413
Volume Fees	\$289,300	\$310,800

Creditors engaged in this state in entering into consumer credit transactions or those having an office in this state who take assignments of and undertake direct collection of payments must file notification and pay a \$15.00 annual fee for each office or store in this state.

They must also pay a volume fee of \$15.00 per \$100,000, or part thereof in excess of \$10,000, and which is above the first \$100,000, of consumer credit sales, loans or leases made during the year.

The additional fees of \$310,800 are based on the average unpaid balances and were paid by the following:

<u>Fees</u>	<u>Volume</u>
\$ 71,805 by Licensed Supervised Lenders on	\$ 478,697,517
238,995 by Non-Lender Creditors and Assignees (retail dealers, professionals, and service organizations) on	<u>1,593,300,000</u>
<u>\$310,800</u>	<u>\$2,071,997,517</u>

Part VII. Problems of People of Small Means in Obtaining Credit

Persons of small means encounter difficulty in obtaining credit. Aside from the obvious socio-economic reasons for this difficulty, another reason has been the lack of lenders who are willing to make small short term loans to consumers.

The dollar amount on which 36% may be charged is \$780 and the dollar amount on which 21% may be charged is \$2,600 or an alternative of 18%. In addition to these rates, a prepaid finance charge of 2% may be charged. These rates do induce lenders to make small loans on terms long enough to generate a reasonable profit, but small loans of shorter terms (less than \$780 and 90 days) to help consumers meet monthly household needs are not available, except by lenders who have taken advantage of the current laws that allow substantial charges on small, short term loans. The consumer is at a considerable disadvantage under the present system. Many other states have passed legislation to resolve this problem. This office will actively seek legislation to correct this problem.

Part VIII. Extent to Which Rules of the Administrator are in Harmony with those of Other Code States.

We continue to consult all other states with Uniform Consumer Credit Codes during the course of issuing any regulations or changes. Although all code states have made unique modifications, the code remains uniform in the basic intent of the legislation.

The American Conference of Uniform Consumer Credit Code States holds an annual meeting of the administrators of the eleven states involved. At these meetings the administrators review and compare what is believed to be unusual or isolated situations, matters, or problems that have arisen in their state and a consensus of the solutions offered by the various state administrators is adopted as a guide for handling similar matters that may arise in the future. For the most part, if the problem does not involve rate, the solution in each state can usually be harmonious and uniform. It is usually found that the problems and situations that develop in the administration of the Uniform Consumer Credit Code are the result of new federal legislation or rules and regulations that affect the operation of our state laws concerning consumer credit. These meetings prove to be most important, meaningful and educational for the administrator.

PERFORMANCE AUDIT REPORT

REVIEWING STATE REGULATION OF BANKERS THRIFT AND LOAN COMPANY

OBTAINING AUDIT INFORMATION

This audit was conducted by Ron Green, Senior Auditor, and Cindy Denton and Cindy Lash, Auditors, of the Division's staff. If you need any additional information about the audit's findings, please contact Mr. Green at the Division's offices.

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REVIEWING STATE REGULATION OF BANKERS THRIFT AND LOAN COMPANY

Summary of Legislative Post Audit's Findings

Bankers Thrift and Loan Company was an investment certificate company operated under the regulation and oversight of the Consumer Credit Commissioner's Office. Bankers Thrift declared bankruptcy in June 1991, leaving investors without access to their money -- about \$9 million in investment certificates.

How were investment certificate companies regulated, and did this regulatory system appear to be reasonable? The regulatory system over investment certificate companies was generally reasonable, but the laws establishing the Kansas Investment Certificate Guaranty Fund had several basic design flaws. One flaw was the lack of a requirement for a regular review to ensure the amount in the Fund was adequate to cover its potential obligations. Another flaw was that money in the Guaranty Fund could be used to bail out a struggling company or purchase its assets, rather than to ensure that investors would be paid off to the guaranteed level if a company failed.

Did the Consumer Credit Commissioner and the Kansas Investment Certificate Guaranty Corporation follow all applicable laws, rules, regulations, and internal policies in regulating investment certificate companies? The Consumer Credit Commissioner examined companies as required by law, but failed to deal effectively with the problems those examinations uncovered. Many of the actions the Commissioner's Office took were not formally documented, and there was little evidence of appropriate follow-through to ensure that problems were corrected. Commissioners also allowed companies to continue issuing investment certificates when the companies' delinquency rates exceeded the level allowed by State law and regulation. In 1989, the Commissioner allowed \$1 million from the Guaranty Fund to be used to buy out most of Prudential's delinquent loans, and allowed Bankers Thrift to acquire Prudential and the other remaining company. While spending money for that purpose was legal, it appeared to have been designed to help the companies more than the investors whose deposits were supposed to be guaranteed by the Fund. When the Commissioner's Office finally took action to close Bankers Thrift in June 1991, the shutdown was handled so poorly that insiders withdrew more than \$61,000 on or after the day of the closure.

Will investors recover any money from Bankers Thrift or from the Guaranty Fund? It appears that investors in Bankers Thrift, Prudential, and Universal should receive some of their money back before the end of 1992. The plans approved by the U.S. Bankruptcy Court call for distributions to be made in three phases, over the next two years or so. If assumptions made by the current Consumer Credit Commissioner prove to be correct, investors would eventually receive about 90 percent of the face amount of their certificates.

This report includes one recommendation for improving the operation of the Consumer Credit Commissioner's Office. We would be happy to discuss this recommendation and the other items in the report with any legislative committees, individual legislators, or other State officials.


Barbara J. Hinton
Legislative Post Auditor

Reviewing State Regulation of Bankers Thrift and Loan Company

Investment certificate companies are statutorily created financial institutions licensed and regulated in Kansas by the Consumer Credit Commissioner. They raise funds by selling investment certificates to the public, and loan money to the public for any consumer purpose. These certificates are unsecured notes showing that the company is indebted to the certificate holder in the certificate's face amount. Investment certificates are not federally insured like investments in banks, savings and loans, or credit unions. Under a State law passed in 1981, the Kansas Investment Certificate Guaranty Corporation was established to protect investors' individual accounts up to a maximum of \$10,000. The law clearly said the Guaranty Corporation was not an agency of the State or federal government.

In 1980, there were about 15 investment certificate companies doing business in Kansas. By 1986, only three companies remained — Bankers Thrift and Loan Company (headquartered in Leawood), Prudential Loan and Investment Association (Hays), and Universal Financial Services (Manhattan).

In 1989, the Consumer Credit Commissioner considered a number of options for dealing with the escalating financial problems of Prudential Loan and Investment. The Commissioner and the Guaranty Corporation decided to allow the use of \$1 million in the Guaranty Fund to purchase some of Prudential's delinquent loans, and allowed Bankers Thrift to acquire Prudential and Universal. Prudential was merged into Bankers Thrift at the end of 1989, and Universal continued to operate as a subsidiary of Bankers Thrift.

Bankers Thrift was not able to overcome the financial problems it assumed when it acquired Prudential. On June 4, 1991, the Consumer Credit Commissioner ordered that Bankers Thrift and Universal be closed. On June 19, 1991, the two companies filed for bankruptcy. Since that date, investors have not been able to withdraw any of their investments, which totaled nearly \$9 million.

Legislative questions have been raised about the role of the Consumer Credit Commissioner in this situation, and about whether investors will be able to recover any of their money. Concerns also have been raised that certificate holders may have been misled when they were told their investments were guaranteed for up to \$10,000, given the fact there was less than \$500,000 left in the Guaranty Fund after the buy-out of Prudential's bad loans.

The scope statement approved for this audit included five questions. For reporting purposes, those five questions have been condensed into three, as follows.

- 1. How were investment certificate companies regulated, and did this regulatory system appear to be reasonable?**
- 2. Did the Consumer Credit Commissioner and the Kansas Investment Certificate Guaranty Corporation follow all applicable laws, rules, regulations, and internal policies in regulating investment certificate companies?**
- 3. Will investors recover any money from Bankers Thrift or from the Guaranty Fund?**

In addition to the main audit questions, we were also asked to seek answers for a list of ten additional questions that were not a part of the approved scope statement. Those questions are covered in Appendix A.

To address these sets of questions, we reviewed the laws and regulations governing investment certificate companies. We interviewed the current Consumer Credit Commissioner, two former Commissioners, and various other people who had knowledge about what happened or how decisions were made. We also reviewed documents on file at the Commissioner's Office, at Bankers Thrift, and at the bankruptcy court.

In general, we found that the statutory system for regulating investment certificate companies was reasonable, except for several provisions relating to the Guaranty Fund. We found that the Consumer Credit Commissioner's Office was aware of longstanding problems in the operation of Prudential Loan and Investment, but did not take strong action to ensure that the problems were corrected. As a general rule, the Commissioner's Office settled for paper compliance with regulatory standards, rather than addressing the underlying problems that placed investors at risk. On more than one occasion, Commissioners allowed investment certificate companies to operate in violation of the laws and regulations governing delinquent loans. Based on assumptions made by the current Commissioner, investment certificate holders could receive about 90 percent of their money over the next two years or so.

In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office, except we did not independently verify the accuracy of computer-generated data provided by the Consumer Credit Commissioner and Bankers Thrift.

The next section of the report outlines the essential elements of the investment certificate business and summarizes the key actions that eventually led to the demise of the industry in Kansas. Beginning on page 7, the audit findings are covered in detail.

Overview of the Development and Demise of the Investment Certificate Business in Kansas

Investment certificate companies have operated in Kansas since the 1920s under names such as industrial loan companies, loan and investment companies, and thrift and loan associations. The investment certificate company with the longest continuous operation in Kansas was Universal Financial Services of Manhattan, which was founded in 1921.

In 1955, the Kansas Legislature passed the Kansas Consumer Loan Act and created the Office of Consumer Credit Commissioner to administer that law. In 1961, the Legislature enacted the Kansas Investment Certificate Act, regulating the issuance of investment certificates under the supervision of the Consumer Credit Commissioner. Investment certificates could be sold only to residents of Kansas.

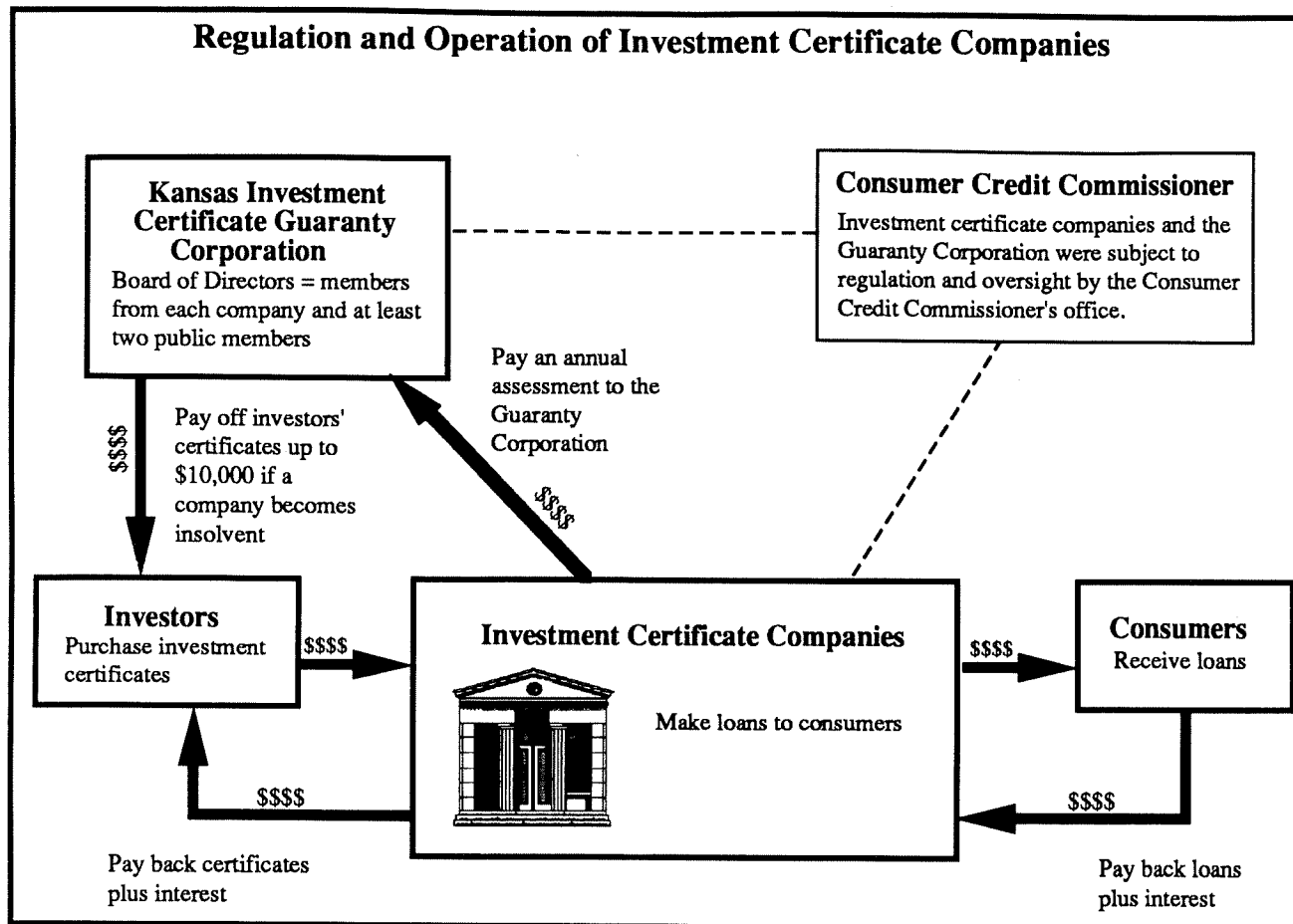
The Kansas Investment Certificate Guaranty Fund Act was created in 1981, at the request of the industry. Following the 1980 legislative session, the Special Committee on Commercial and Financial Institutions held hearings on a bill proposed by the Kansas Association of Finance Companies which would create a guaranty fund for investment certificates. Testimony by representatives of finance companies indicated that a guaranty fund would serve two purposes: it would assure the public that investment certificates would be repaid, and based upon that added security it would increase sales of investment certificates.

Representatives of one large investment certificate company opposed the legislation, stating that the fund would be too small to handle claims against it in the first few years. The Special Committee recommended a bill creating a guaranty fund, which was passed nearly unanimously by the 1981 Legislature.

The legislation creating the Guaranty Fund also created the Kansas Investment Certificate Guaranty Corporation, a private corporation which all companies selling investment certificates were required to join. The purpose of the Corporation and the Guaranty Fund was to guarantee the payment of investors' certificates up to an aggregate maximum of \$10,000 for individual accounts, and up to an additional \$10,000 for all joint accounts. The 1981 legislation clearly stated that the Guaranty Corporation was a private entity, not backed by the State of Kansas or the federal government.

By law, the board of directors of the Guaranty Corporation had to include representatives of the investment certificate companies and representatives of the public. To further ensure that the Guaranty Corporation was operated properly, all of its activities were placed under the regulation and oversight of the Consumer Credit Commissioner.

When the Guaranty Fund was created, 14 member companies were selling investment certificates in Kansas and paying assessments into the Guaranty Fund. The basic operation of investment certificate companies was much like other financial institutions, taking in money from depositors (at a specified interest rate) and loaning money to consumers (at a higher interest rate). The structure of the investment certificate business is demonstrated in the chart on the next page.



Like a bank or a savings and loan, an investment certificate company could only operate profitably if all or nearly all the borrowers repaid their loans, and the interest rate borrowers paid was enough higher than the interest rate paid to depositors. The main difference was that deposits in banks and savings and loans were insured up to \$100,000 per account by an agency of the federal government, while investment certificates were protected only up to the \$10,000 level by a private corporation that was not backed by the State or federal government.

By the end of 1986, only three investment certificate companies remained in operation. Those three companies were Bankers Thrift and Loan Company (headquartered in Leawood), Prudential Loan and Investment Association (Hays), and Universal Financial Services (Manhattan). All the other companies that had been members of the Guaranty Corporation had gotten out of the investment certificate business and paid off their depositors, without any expenditure of moneys from the Guaranty Fund.

In mid-1987, the Guaranty Corporation found it could no longer obtain insurance for the members of its board of directors. Because they were no longer insured, the two public members resigned immediately. In August 1987, the board found that liability insurance could be purchased for \$25,000 per year, but the board members declined because they thought it was too expensive.

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The financial problems of Prudential Loan and Investment Company worsened dramatically in 1987 and 1988. Prudential's independent audit reports showed a net loss of about \$272,000 in fiscal year 1987 and \$358,000 in fiscal year 1988. Prudential's loan repayments were declining, and its percentage of delinquent loans was rising. As a result, the company was having more and more difficulty staying in compliance with regulatory requirements. The company's financial audit for fiscal year 1988 said its regulatory capital was more than \$388,000 below legal requirements, which raised substantial doubt about its ability to continue in business.

By the early part of 1989, the Consumer Credit Commissioner began taking steps to close Prudential. In February 1989, the Commissioner wrote a letter to the Attorney General, seeking advice about the procedures to follow if the Commissioner decided to take possession of Prudential's assets. However, before the Commissioner could take action, the Federal Deposit Insurance Corporation (FDIC) took over First of Kansas Financial Corporation, a holding company that owned Prudential and a savings and loan in the Hays area. The Federal Deposit Insurance Corporation remained in control of Prudential for about six months, while the Commissioner tried to decide how to handle the problems.

At the end of 1989, Bankers Thrift acquired Prudential and Universal. After considering numerous options for selling or liquidating Prudential, the Commissioner eventually decided to allow Bankers Thrift to purchase Prudential for a dollar, and to allow the Guaranty Fund to buy or "pay off" \$1 million of Prudential's non-performing loans. (The amount of Prudential's bad loans had been estimated at \$1 million to \$1.2 million by the Commissioner's Office, the Federal Deposit Insurance Corporation, and Bankers Thrift.) At about the same time, Bankers Thrift also acquired ownership of Universal. It was thought that the two stronger companies — Bankers Thrift and Universal — could absorb and correct the financial problems known to exist at Prudential.

The Kansas Investment Certificate Companies, Before and After the Sale of Prudential

1986-88:

Three Separate Companies

Prudential (owned by First of Kansas
Financial Corporation)

Universal

Bankers Thrift

End of 1989:

One Company and a Subsidiary

Bankers Thrift (owned by First Kansas
Capital Corporation)

Universal (subsidiary of Bankers Thrift)

By early 1990, it became apparent that Prudential's loan delinquencies were much higher than had been thought when the loan portfolio was evaluated in mid-1989. As early as February 1990, Bankers Thrift officials estimated another \$500,000 in bad loans would have to be charged off. The new Consumer Credit Commissioner said he would work with Bankers Thrift while the company tried to get the loan delinquencies under control. By the end of 1990, liquidation of Bankers Thrift and Universal was being discussed, but the Commissioner wanted to wait until the companies' 1990 financial audit was done before making a decision.

Bankers Thrift's independent audit for 1990 led the Commissioner to close Bankers Thrift and Universal in June 1991. The financial audit report for 1990 showed that Bankers Thrift and Universal had a net loss of more than \$660,000 in 1990, and had a net capital deficiency that raised substantial doubt about its ability to continue as a going concern. The Consumer Credit Commissioner's office apparently received a copy of the audit on May 9, 1991. According to minutes of a May 14 meeting of the Commissioner and the Guaranty Corporation, the general consensus was that Bankers Thrift and Universal would have to be liquidated.

In a May 30, 1991, letter to the Governor, the Commissioner advised that Bankers Thrift and Universal were insolvent, and that the institutions would be placed in receivership on June 4. On June 4, 1991, the Commissioner sent three representatives to the Leawood headquarters of Bankers Thrift, and ordered that all offices of Bankers Thrift and Universal be closed immediately. Despite those orders, a number of transactions were made on June 4 and June 5, some of which involved accounts of company employees.

On June 19, 1991, Bankers Thrift and Universal filed for bankruptcy in the U. S. Bankruptcy Court for the District of Kansas. The president of Bankers Thrift sent a letter to all certificate holders on July 22, 1991, explaining his position that filing for bankruptcy was preferable to the other two alternatives: injecting more than a half million dollars into the company's capital structure, or allowing the Consumer Credit Commissioner to liquidate the companies, with a possible recovery of only 25 to 30 percent of the investors' money.

The management of Bankers Thrift and Universal filed a proposed reorganization plan in May 1992, which would have allowed the companies to continue in operation. That plan was rejected by a vote of the companies' creditors, who were certificate holders.

An alternative plan was filed in August 1992, providing for complete liquidation of Bankers Thrift and Universal over a two-year period. That plan was approved by a vote of the creditors, and confirmed by the bankruptcy court in September 1992. The plan called for cash distributions to be made in three phases. The first phase covered the companies' liquid (cash) assets, the second phase covered the money in the Guaranty Fund, and the third phase covered money gained as non-liquid assets (such as consumer loans) are collected or sold.

The current Consumer Credit Commissioner has been designated as one of the bankruptcy trustees for the certificate holders of both Bankers Thrift and Universal. The trustees' role is to oversee the liquidation process, and to ensure that all steps are done according to established rules and procedures as outlined in the approved plan. Appendix B includes a more complete summary of the key events and dates in this entire matter.

Although there are no longer any investment certificate companies actively operating in Kansas, the Consumer Credit Commissioner's Office continues to regulate and monitor supervised lenders and retail credit grantors in Kansas. In 1990, there were 232 licensed supervised lenders in Kansas. State law requires those lenders to be examined at least once a year. Licensed lenders include consumer finance companies such as Beneficial or Household Finance. Also in 1990, there were 5,376 retail credit grantors in Kansas. Those businesses that offer to sell on credit have to register with the Consumer Credit Commissioner's Office and pay annual registration fees and additional fees based on their dollar volume of consumer credit sales.

How Were Investment Certificate Companies Regulated, And Did This Regulatory System Appear to Be Reasonable?

This question dealt strictly with the design and structure of the regulatory system, while the next question dealt with the way the regulations were implemented. After reviewing Kansas statutes and regulations, we concluded that the statutory system for regulating investment certificate companies in Kansas generally appeared to be adequate. The law included provisions to prevent problems from developing, to provide oversight by the Consumer Credit Commissioner so that problems could be identified early in their development, and to give the Consumer Credit Commissioner broad discretion in taking corrective actions when needed. However, the law establishing the Kansas Investment Certificate Guaranty Corporation had some basic design flaws related to monitoring the Guaranty Fund and the use of the money. These findings and related information are found in the following sections.

Generally, the Statutory Arrangement for Regulating Investment Certificate Companies Appeared to Be Adequate

To protect the public, a reasonable regulatory system for financial institutions would be expected to include elements that would:

- prevent problems from occurring
- identify problems on a timely basis
- provide ways to correct problems

Prevention of problems could be accomplished by providing companies with guidelines and requirements they must meet to enter and continue in business. Identification of problems could be done through independent examinations, audits, and administrative reviews. A regulatory agency also must follow up on problems and have the authority to take corrective actions when necessary. We found that the Kansas investment certificate regulatory system had all the basic elements of an adequate regulatory system.

Kansas law included provisions designed to prevent investment certificate companies from having problems. A prospective investment certificate company had to have at least \$150,000 in capital, be examined by the Consumer Credit Commissioner's Office, and receive the approval of the Commissioner before beginning operation. Once in business, a company had to maintain a financial reserve equivalent to 10 percent of all outstanding investment certificates.

To avoid misleading the public, an investment certificate company could not advertise in a manner that might lead investors to think it was a bank or its deposits were backed by the federal or State government. By law, each investment certificate had to state that "Funds in investment certificates owned by a single investor are protected up to an aggregate maximum of \$10,000 by the Kansas investment certificate guaranty fund corporation, a private corporation which is not an agency of the state of Kansas or of the federal government."

Companies were limited as to the total dollar amount of investment certificates they could issue. The law clearly stated financial standards that each investment certificate company would have to meet, such as maintaining a certain amount of equity relative to the company's debt and keeping the amount of delinquent loans below the level specified in the regulations.

Kansas law provided ways for the Consumer Credit Commissioner to monitor companies and identify problems on a timely basis. Each investment certificate company was required to provide the Commissioner and the Guaranty Corporation with an annual independent financial audit, and to have an annual examination by the Consumer Credit Commissioner's office. These two reports gave the Commissioner the opportunity for regular oversight. The Commissioner also had the authority to conduct additional examinations at the company's expense or review company records, as needed.

Kansas law provided broad discretion for the Consumer Credit Commissioner to enforce the law and require corrective actions. The Commissioner had the authority to require companies to correct problems that were identified. If companies failed to comply they could be penalized, although the Commissioner was not authorized to levy fines against them.

The Commissioner's authority covered most areas. If a company could not stay under the limitations provided for delinquent accounts, the Commissioner could rescind its authority to sell investment certificates, and it would not be eligible to maintain its membership in the Guaranty Corporation. The Commissioner also had broad discretion in determining if a company had insufficient capital, was violating the law, or was operating in an unsafe manner. To correct any of these situations, the Commissioner could take possession of the company, and could return it to operation or liquidate its assets.

The regulatory structure for the Kansas investment certificate companies was similar to that used in other states that we contacted and similar to the regulation of other Kansas financial institutions. (For more about the regulation of Kansas' financial institutions, see Appendix C.) Actual procedures and standards differed somewhat, but the design of each set of regulations was intended to prevent, identify, and correct problems.

The other states we contacted were Iowa, Nebraska, and Utah, all of which allowed and regulated some form of investment certificate companies. As in Kansas, the investment certificates in those states were backed by private organizations, and the industry has collapsed in recent years. The amounts of the guarantees ranged from \$10,000 in Iowa to \$30,000 in Nebraska. In Utah, the investors ultimately received about 95 percent of their funds, following a settlement with the state. In Nebraska, investors received 60 to 90 percent of their guaranteed funds back. In Iowa, investors received only about 40 percent of their funds back.

The Law Establishing the Guaranty Fund Included Several Basic Design Flaws

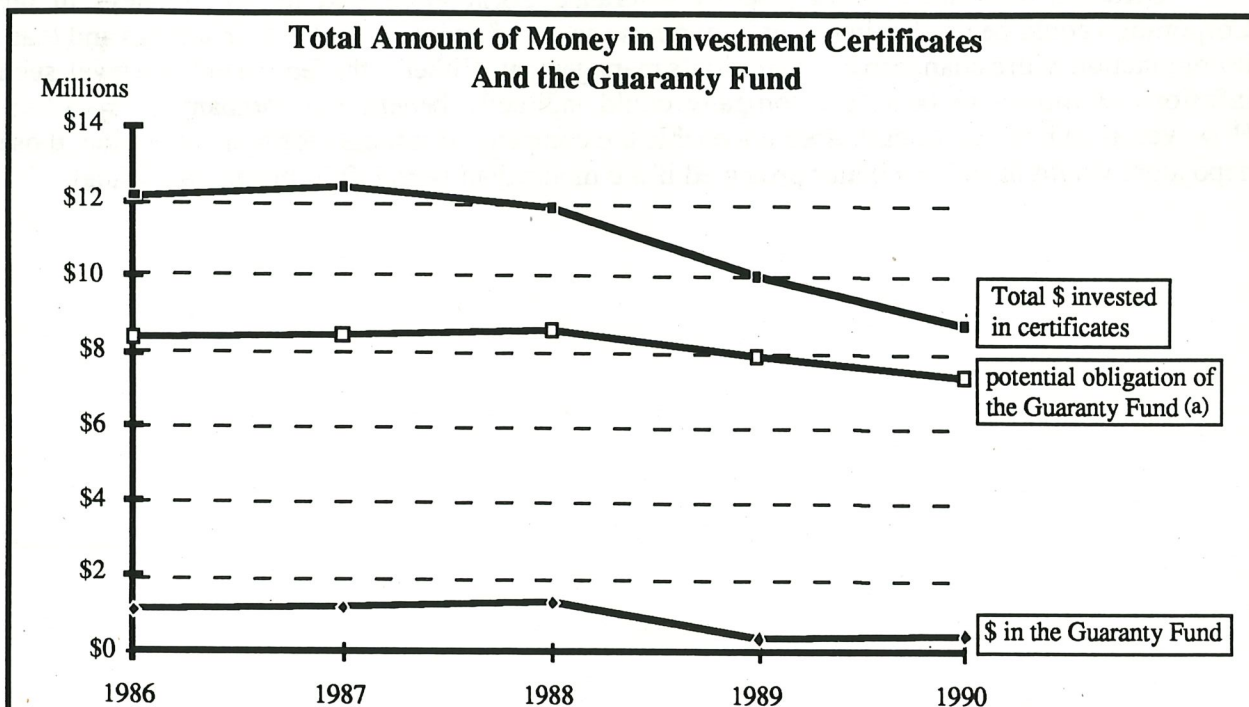
To protect the investing public, a reasonable regulatory system for a private guaranty fund would be expected to include the following:

- public representation on the board of directors
- guidelines for safely investing the fund's money
- a method for ensuring that the fund was big enough to protect investors
- required financial audits of the fund
- reasonable limits on the use of funds for the protection of investors

We found that the first two of these elements were covered adequately in State law, but the other three elements either were left out or were not clearly enumerated in the Kansas Investment Certificate Guaranty Fund Act. The areas of weakness are outlined below.

State law did not require a regular review of the Fund balance to determine if it was adequate. When the Guaranty Fund was established in 1981, a formula for determining company assessments was put into law. Since that time the Fund grew steadily, without any payments to investors, until 1989, when two-thirds of the Fund was used to buy Prudential's bad loans.

By 1986, the number of member companies supporting the Guaranty Fund had dropped to three from an original membership of more than a dozen. This drop in membership seriously impaired the possibility of building up the Fund if its moneys were spent for any reason. After 1989, only about half a million dollars remained in the Fund to meet potential obligations of about \$8 million. State law did not require anyone to evaluate the continuing viability of the Guaranty Fund. The following chart shows the Fund balances between 1986 and 1990.



This line chart shows the total Statewide amount invested in certificates, the potential obligation of the Guaranty Fund for those investment certificates, and the amount in the Guaranty Fund at the end of each year. In 1989, the Consumer Credit Commissioner authorized the Guaranty Fund to purchase \$1 million of Prudential's bad loans. This left a balance in the Guaranty Fund of about \$375,000.

	1986	1987	1988	1989	1990
Guaranty Fund as a % of Potential Obligations (a)	12.3%	13.3%	14.4%	4.7%	6.0%

(a) The potential obligation of the Guaranty Fund was estimated using the total dollar amount of certificates under \$10,000, plus \$10,000 for each certificate greater than \$10,000.

State law did not require an annual audit of the Guaranty Corporation. Annual independent financial audits were not required by law, but were required by the Corporation's bylaws. These audits provided the Consumer Credit Commissioner with information for monitoring the status of the Fund, but they did not assess the adequacy of the Fund to cover its potential obligations. If the audit requirement had been set out in law, the audits might have been more useful and the decision to have the Corporation audited would not have been left to its board of directors.

The use of the Investment Certificate Guaranty Fund was not limited to payments to certificate holders. Kansas statutes gave the Consumer Credit Commissioner and the Guaranty Corporation's board of directors wide latitude in the use of the Guaranty Fund. With the approval of the Commissioner, money from the Fund legally could be used to make loans, make contributions, purchase assets, or invest in a company to prevent the company from defaulting on payment of its investment certificates.

Officials with the Federal Deposit Insurance Corporation told us that moneys in the Corporation could be used to invest in or purchase assets of an insolvent bank or savings and loan, in conjunction with a change in an institution's management. Either at the federal or State level, such infusions of money to benefit a company could indirectly benefit the company's depositors. However, if an infusion of cash does not enable the company to resume profitable operation, those depositors would have been better protected if the money had been left in the guaranty fund.

Did the Consumer Credit Commissioner and the Kansas Investment Certificate Guarantee Corporation Follow All Applicable Laws, Rules, Regulations, and Internal Policies In Regulating Investment Certificate Companies?

The Consumer Credit Commissioner examined companies as required by law, but failed to deal effectively with the problems those examinations uncovered. Many of the actions the Commissioner's Office took were not formally documented, and there was little evidence of appropriate follow-through to ensure that problems were corrected. The Kansas Investment Certificate Guarantee Corporation, which was supposed to provide a safety net for investors, ended up functioning without any public representation, and moneys in the Corporation's Guarantee Fund were used primarily in a failed attempt to shore up the industry rather than to guarantee amounts Kansas residents had invested in the investment certificate companies. These and other related findings are discussed in the following sections.

The Consumer Credit Commissioner's Office Repeatedly Uncovered Problems Through its Examinations of Investment Certificate Companies, But It Failed to Deal Effectively with Them

The Commissioner's Office conducted annual examinations of each investment certificate company, as required by State law. However, our review of examinations for Prudential and Bankers Thrift showed that, frequently, there was no documentation to indicate the Commissioner's Office had discussed problems identified in the examinations with the companies. In addition, there generally was nothing to indicate whether the companies had corrected the problems. (We did not review examinations for Universal.)

During the period leading up to the sale of Prudential and the bankruptcy of Bankers Thrift, three different persons served as Consumer Credit Commissioner. Don Phelps was Commissioner from 1982-1985. He was followed by Judy Bravence-Stringer, who had managed an investment certificate company (the Morris Plan) for 12 years, and served as Commissioner from 1986-1989. Neil Arasmith was Commissioner from February 1990 through September 1991, after having been a State Senator and having managed a consumer loan office for 25 years.

Over the years, Commissioners were lax in responding to problems identified in examinations. Those examinations showed that both Bankers Thrift and Prudential had violated the Investment Certificate Act in nearly every year we reviewed, and the same violations were frequently repeated from year to year. For example, Prudential was cited for poor loan documentation (primarily failure to run credit checks on borrowers and acceptance of inadequate collateral for loans) in every year but one between 1982 and 1989. And in 1985, 1986, and 1988, examiners found Prudential had a 90-day delinquency rate in excess of the five percent standard established in State regulations.

The Commissioner's Office did not appear to take much action to ensure that Prudential's identified problems were addressed promptly. Officials sometimes wrote letters to the companies spelling out the violations, but we could find no letters to Prudential followings the examinations for

1984, 1985, and 1987. When the Commissioner did send letters, there often was minimal response from the companies and no subsequent action by the Commissioner.

Ex-Commissioner Bravence-Stringer said she discussed the examination results with the companies at great length, and gave them specific directives to come into compliance, which she said they always did. We found evidence that on one occasion Prudential's right to issue investment certificates had been suspended after the annual examination showed the delinquency rate to be in excess of the amount allowed by law. However, overall it appears that whatever system existed for correcting problems was largely informal, and not systematically documented.

The Commissioner's Office settled for paper compliance with requirements rather than addressing underlying problems. Prudential's response when cited for delinquency or inadequate capital generally involved injection of either new capital or "good loans" from its parent company.

**Collateral Often Was Not Adequate
To Secure Loans Made by Prudential**

Prudential had a long history of poor loan practices. In 1988, the last year Prudential was formally examined by the Consumer Credit Commissioner's Office, the examiner noted that only 80 percent of Prudential's loans were secured, that the collateral for more than one-third of the loans was not properly insured, and that 45 percent of the borrowers had not had their credit checked. These factors contributed to Prudential's difficulty in recovering its money when borrowers could not make their payments.

The loans listed below are part of the group of Prudential's non-performing loans that were purchased by the Guaranty Corporation for \$1 million. The loans shown here were made in 1988 and 1989. The collateral (when there was any) provided little for the company to recover against. To date, about \$93,000 has been collected on the \$1 million in bad loans.

<u>Loan Amount</u>	<u>Collateral</u>
\$ 38,009	2 cows and junk pickup
34,573	None
30,349	None
29,657	1979 Ford Bronco 4x4
	1979 Mercury Grand Marquis
29,583	1978 GMC Van
	1979 Pontiac Gran Prix
23,278	None
17,718	None
15,012	None
14,616	1979 Olds Delta 88
	1979 Ford Van
13,556	1980 International Scout

While this accomplished "paper compliance" with the requirements, it did not address Prudential's underlying problem of continuing to make loans without credit checks or adequate collateral. Loans made under these conditions are at higher risk for default, and provide less opportunity for recovery in the event of default. The accompanying box shows the loan amounts and collateral for some of Prudential's problem loans.

Prudential also masked its delinquency rate by rolling over, or refinancing, loans when they came due, which prevented the loans from being treated as delinquent. Officials and staff at the Commissioner's Office over the years were aware that Prudential was using refinancing to control its delinquency rate. Ex-Commissioner Bravence-Stringer said Prudential officials were advised that this was a poor business practice, which would lead to bigger problems in the future. Bravence-Stringer said, however, that as long as Prudential stayed within the ratios required by law, there was nothing else she could do about such practices.

Commissioners exceeded their authority in using informal agreements to deal with problems. Prudential's 1988 examination revealed a delinquency rate of nearly eight percent, which far exceeded the five percent allowed by State regulations. According to

handwritten notes, Commissioner Bravence-Stringer gave Prudential 60 days to correct the problem, but the company was unable to do so. At that point, she reportedly informally asked Prudential officials to stop selling investment certificates, and Prudential complied with her request. There is no written documentation of this request.

Similarly, in 1990, Commissioner Arasmith allowed Bankers Thrift to continue issuing certificates even though its delinquency rate exceeded 20 percent. Arasmith stated that he agreed to exercise forbearance on the delinquency ratio as part of the deal for Bankers Thrift to acquire Prudential.

State law said that an investment certificate company had to stay within the delinquency standards (set in the regulations) to maintain authority to issue investment certificates. The Commissioners did not have authority to waive the regulation which set the maximum acceptable delinquency level at five percent. (A recent Attorney General opinion affirmed that a State agency cannot waive or violate its own rules and regulations.) By not responding to the companies' delinquency rates in the manner called for in State law, the Commissioners placed investors at risk.

**The Kansas Investment Certificate Guarantee Fund Was Used
In an Attempt to Bail Out Companies in the Industry,
Rather than as a Safety Net for Investors**

Legislation authorizing the Guaranty Corporation and the Guaranty Fund clearly emphasizes the role of these entities in protecting the public from financial losses. In doing so, the statutes allow the Fund to be used in a variety of ways, all with the goal of helping ensure the safety of investors' money. However, the only significant expenditures from the Fund to date have been to help investment companies stay afloat when they were in violation of State law and regulations.

The Consumer Credit Commissioner's Office and the Guaranty Corporation attempted to stabilize one of the Corporation's weak members by using \$1 million of the Fund's money to purchase bad loans generated by the member. State law allows moneys in the Fund to be spent under the following circumstances:

- if a member company has been liquidated and the proceeds of liquidation are insufficient to meet the company's obligation to investors up to the \$10,000 limit, the Fund shall be used to pay deficiencies at the direction of and in amounts determined by the Commissioner
- in order to prevent a member company from defaulting on payment of investment certificates, or to assist a member who has defaulted, the Fund may, with the approval of the Commissioner, be used to make loans or contributions to, or purchase the assets of, or invest in, the member company on terms agreed to by the Corporation and the member company
- to pay for an independent audit of a member company
- to pay routine operating expenses of the Corporation

From its inception in 1982 until Fall 1989, the only expenditures from the Fund were for routine operating expenses of the Corporation. In October and November 1989, the Commissioner and the Corporation agreed to use up to \$1 million of the Fund to purchase bad loans from Prudential in order to sell it to Bankers Thrift, and prevent it from defaulting on its certificates.

As noted earlier, Prudential had a long history of loan deficiencies. For years, the company made loans without verifying the creditworthiness of potential borrowers, and accepted inadequate collateral for the loans. In 1987, the economy of Hays turned downward when the price of oil dropped and the town's major employer closed. Many borrowers were unable to make payments on their loans, and, with insufficient collateral, Prudential had few means to recover its money. Its problems continued through 1989, when the Commissioner and the Guaranty Corporation began considering whether Prudential could be salvaged as a company if it were under new ownership, whether its assets (loans) could be profitably sold, or whether it should be liquidated. The situation was further complicated by the fact that the Federal Deposit Insurance Corporation took over operation of Prudential and its affiliated savings and loan for six months in 1989.

Liquidation was considered a last resort by many of the people involved. Ex-Commissioner Bravence-Stringer stated that, at a minimum, investors of more than \$10,000 would have lost money if Prudential were liquidated, even if the entire Guaranty Fund were used to supplement the company's assets. The other member companies, Bankers Thrift and Universal, were reportedly concerned that liquidation of Prudential would cause a "run" on their operations, and that the Guaranty Fund would be insufficient to bail out all three companies.

The solution eventually agreed to involved Bankers Thrift purchasing both Prudential and Universal. The Commissioner and the Board of the Guaranty Corporation agreed that, in order to stabilize Prudential, the Fund would purchase \$1 million of Prudential's non-performing (probably uncollectible) loans. The box on the facing page describes the various options considered before Prudential was sold to Bankers Thrift, and addresses concerns that have been raised about the sale, including whether it involved a conflict of interest on the part of officials of Bankers Thrift.

The Fund balance at the time of the purchase was approximately \$1.4 million. Thus, the purchase of Prudential's loans virtually depleted the Fund. By using the Fund to shore up Prudential, the Commissioner and the Corporation severely impaired the Fund's value as a safety net for investors.

Investment certificate companies continued issuing new certificates after the buyout, even though the Fund was nearly depleted and Bankers Thrift's delinquent loans exceeded allowable levels. From the time it purchased Prudential and Universal in late 1989, Bankers Thrift's delinquency rate soared, exceeding 20 percent in both 1990 and 1991. Yet the company was allowed to continue selling investment certificates, which put additional investors at risk. This arrangement was in violation of State law, which required that a company be excluded from membership in the Guaranty Corporation if it could not stay within the delinquency limits. And, if a company was not a member of the Guaranty Corporation, it would be unable to sell new certificates.

In addition, even though the Fund was nearly depleted, investment certificates continued to carry the following language, as required by statute: "Funds in investment certificates owned by a single investor are protected up to an aggregate maximum of \$10,000 by the Kansas investment certificate guaranty fund corporation, a private corporation which is not an agency of the state of Kansas or of the federal government."

How Prudential Was Sold to Bankers Thrift

By late summer of 1989, Commissioner Bravence-Stringer had reviewed and rejected several bids to buy Prudential or its assets. In August she announced she would accept a bid submitted by Don Nipple, a loan officer at Prudential, with certain modifications. Although Mr. Nipple did not have capital to invest in the company, he apparently had arranged through Joe Karlin, vice-president and manager of Prudential, for one of the company's depositors to exchange \$275,000 in investment certificates for a subordinated debenture, which would be considered as capital and would significantly improve the company's capital situation. In addition, the Guaranty Corporation would loan Mr. Nipple \$750,000. The Board of the Guaranty Corporation (composed of one representative each from Bankers Thrift, Prudential, and Universal) disagreed with the Commissioner, and suggested an alternative plan involving Mr. Nipple, which the Commissioner eventually rejected.

At that point in September 1989, Roger Worden, president of Bankers Thrift, offered to buy Prudential, if he could also buy Universal. Mr. Worden proposed that the Guaranty Corporation purchase \$1 million of Prudential's bad loans, and that he take advantage of the same conversion of \$275,000 in investment certificates to a subordinated debenture by the private depositor. The Board of the Guaranty Corporation voted to approve the sale of both Prudential and Universal, and to allow the use of \$1 million of the Guaranty Fund's money to buy Prudential's bad loans. All three members of the Board had a conflict of interest in voting on these issues, because none of them was independent. Most importantly, Roger Worden was able to participate in voting for a \$1 million buyout of bad loans from the company he was buying. The Commissioner approved the sale and the use of the money from the Guaranty Fund.

Questions have been raised about the conversion of \$275,000 in investment certificates to a subordinated debenture. Joe Karlin, who initially arranged the debenture, told us the owner of the certificates had agreed to the conversion only with the understanding that this would help Don Nipple acquire Prudential, and would help keep Prudential open in Hays. Roger Worden thought that the conversion of certificates for a debenture was essential to the financial success of Bankers Thrift's future operations, and the Commissioner said it was her understanding the debenture was to be available to anyone who purchased Prudential. She contacted Joe Karlin in early December 1989, and told him that if the debenture was not available to Roger Worden, she would have to liquidate Prudential immediately. Mr. Karlin told us he felt coerced, because the debenture was never meant to be used by Roger Worden or Bankers Thrift, but he nonetheless arranged the conversion the next day. The investment certificates involved were owned by the Catholic Church, under the trusteeship of an elderly church official.

In the end, the subordinated debenture was one of the elements that led to the bankruptcy of Bankers Thrift. Although the Commissioner's Office was willing to treat the debenture as owners' equity for purposes of meeting the company's capital requirements, independent auditors pointed out that such treatment did not comply with generally accepted accounting standards. When the debenture was reclassified from equity to debt during the 1990 independent audit by a certified public accountant, Bankers Thrift could no longer meet regulatory requirements for capital, and the Commissioner began action to close it down.

This brings into question whether the Commissioner and the Corporation were acting in good faith, and in the best interests of the public. When an investment certificate company exceeded the allowable delinquency rate, presumably the Commissioner would allow the company a reasonable, but limited, amount of time to come into compliance. By allowing Bankers Thrift to operate with excessive delinquencies for a year and a half, the Commissioner and the Corporation appeared to be protecting the company, more than the investors.

**When it Finally Took Action to Close Bankers Thrift and Universal,
The Consumer Credit Commissioner's Office Botched the Closure,
Which Allowed Insiders to Withdraw Their Funds
From the Investment Certificate Companies**

In late 1990, Commissioner Arasmith considered the issue of liquidating Bankers Thrift, but decided to wait until he received the company's 1990 independent financial audit. That report was completed at the end of March 1991, but was not received in the Commissioner's Office until May 9, 1991. The audit raised substantial doubt about Bankers Thrift's ability to continue as a going concern. At that point, Commissioner Arasmith decided to take action.

Initially, the Commissioner reportedly gave Bankers Thrift officials one week to sell assets before he took possession of the company. On May 14, 1991, the Commissioner met with representative of Bankers Thrift and Universal to discuss the 1990 annual audits of the companies. According to the meeting minutes, all agreed that both companies were out of compliance with the statutes and regulations and the companies should be liquidated. The Commissioner gave Roger Worden, president of both Bankers Thrift and Universal, one week to attempt to sell the loans in Hays and Manhattan. He further indicated he would begin procedures to take possession of the two companies. On May 30th, the Commissioner notified Governor Finney that Bankers Thrift and Universal were insolvent and would be placed in receivership on June 4th (two weeks after his original deadline).

On the day Bankers Thrift and Universal were closed, three officials from the Commissioner's Office were sent to the Leawood office of Bankers Thrift, but no one was sent to the Hays office or to Universal to ensure that all transactions were halted. Officials from the Commissioner's Office arrived at the Leawood office early on the morning of June 4th. They notified President Roger Worden that both Bankers Thrift and Universal were closed by order of the Commissioner, and that no further deposits or withdrawals were allowed. Mr. Worden immediately telephoned officials at the Hays office of Bankers Thrift and at Universal in Manhattan to advise them of the situation, and told them no financial transactions were allowed. The Commissioner's Office did not send staff to either of the other offices to see if they actually closed down.

Some employees took advantage of the knowledge that Bankers Thrift and Universal were being shut down; in all, these employees and others withdrew more than \$61,000 on or after the day of the closure. Our review of account transaction records for Bankers Thrift and Universal showed that some employees at all three offices withdrew a significant amount of money on June 4, 1991.

Comments by Bankers Thrift Depositors

During the audit, we attended a meeting of Bankers Thrift depositors in Hays and requested comments from the depositors regarding what they were told about the protection of their money, and whether they thought they had been misled by anyone. We received about 40 letters in response. Excerpts from some of those letters are listed below.

Many depositors thought they had been misled:

- "Vice-President Joseph C. Karlin...assured us it was perfectly safe, that we were insured by the State of Kansas. We absolutely would not have invested one penny in Bankers Thrift if they had not guaranteed us it was insured by the State of Kansas."
- "When I put my money in Money Market, I was told my money is as safe as any with FDIC."
- "Joe Karlin of Hays said we were insured to \$10,000 with the State. I do think he lied to us."
- "I invested in Bankers Thrift and Loan Association of Hays, Kansas because I was told each account was insured up to ten thousand dollars by the State of Kansas."
- "We were told several times by employees of Bankers Thrift that this [keeping accounts below the \$10,000 maximum] would protect our savings like the \$100,000 insured status of F.D.I.C."
- "We made deposits up to and as late as May 29, 1991, and on June 4th the Bankers Thrift was declared insolvent. Surely someone knew there was grave trouble and yet they continued to take our money."
- "I was assured our money was insured up to \$10,000 per account. I adjusted 3 accounts to that amount, and each time an account was to be renewed, I would spend a few minutes with an employee and was always assured each account was fully insured."
- "...I was assured by Irv Karlin, Joseph Karlin, and other staff members of the Hays office that there were no problems and that the business was financially sound."

Depositors have experienced hardships:

- "I am old. I am 88 years old with only \$208 Social Security check per month. I need the interest I was drawing to go along with the small Social Security check to make my living. Try living on \$208 a month. I do not get any help from anyone. How can they do this to us old people."
- "I do appreciate the fact that some action is being taken. In the mean time, my college-age boy is being forced to work while attending college when he could be spending that valuable time studying."
- "I went by Prudential office the morning they closed the office to withdraw some money for taxes and insurance. I was told the computers were down and to come back in an hour. When I went back the sign was on the door as to the closing. Needless to say, I had to borrow elsewhere and pay interest. And boy was I mad."
- "I am writing this letter for my dad who is in the nursing home partly because of losing his savings...(which was meant to be used for his burial.) Now he is very worried of how he is going to be buried."
- "We are retired and the money tied up in bankruptcy has not made retirement the experience we envisioned. It is not pleasant to lose savings which should have been protected by Kansas law..."

Three Bankers Thrift employees in Hays withdrew a total of \$13,903 on June 4th, while two Universal employees withdrew a total of \$4,547. In addition, accounts for five persons with the same surnames as employees were closed in Hays, and one with the same surname was closed at Universal. These withdrawals totaled \$28,775, and in some cases involved withdrawing a time deposit before its maturity date, thereby incurring a penalty. Two Bankers Thrift employees in Leawood withdrew a total of \$1,100 on June 4th, but most of that amount was redeposited within 10 days.

While it is possible that these transactions may have occurred early in the morning of June 4th before Bankers Thrift and Universal were officially shut down, the nature and pattern of the withdrawals make them suspicious. Also, three accounts totaling \$13,130 were closed at Universal on June 5th, the day after the company was ordered closed.

The June 4th and 5th transactions summarized above totaled about \$61,000. In addition, one large withdrawal -- more than \$17,000 -- was recorded on June 3rd by an employee in the Leawood office of Bankers Thrift. This transaction might be viewed as suspicious, because it involved a significant amount of money and the person was in a position with access to accounting records.

These types of withdrawals by employees and apparent relatives or friends were clearly unethical, and harmed other depositors by reducing the pool of money available for eventual distribution by the bankruptcy court. Because of their withdrawals, these depositors received 100 percent of their money immediately, while other depositors who did not have access to inside information will receive only a percentage of their money, after waiting more than a year and a half.

This situation could not have occurred if the Commissioner's Office had closed the companies properly. For example, when the Federal Deposit Insurance Corporation closes financial institutions, official representatives arrive at each branch office of the institution at the same time, and take charge of the company's operations to prevent any transactions from occurring. In contrast, there were no controls in place to prevent improper transactions when the Commissioner closed Bankers Thrift and Universal.

The current Consumer Credit Commissioner has indicated that he is in the process of investigating avenues in which funds improperly withdrawn can be recovered. He agreed that the Commissioner's Office should have sent a representative to each site to oversee the closing of the books, but he also blamed Bankers Thrift management for not following through to see that unauthorized withdrawals were redeposited.

The information we have gathered about the withdrawals described above will be turned over to the Consumer Credit Commissioner, the Attorney General, and any other appropriate agency, following issuance of this report.

Will Investors Recover any Money from Bankers Thrift or from the Guaranty Fund?

According to assumptions made by the Consumer Credit Commissioner, Bankers Thrift investors should be able to recover about 90 percent of the value of their investment certificates through distributions made in three phases over the next two years. The largest share is to be distributed in the first phase, which is supposed to be done before the end of 1992. These and other findings are discussed more fully below.

Over the Next Two Years, Investment Certificate Holders Could Receive a Total of about \$8 Million, or Roughly 90 Percent Of the Amount of Investment Certificates Outstanding

When Bankers Thrift and Universal filed for bankruptcy protection in June 1991, the companies had a total of \$8,891,000 outstanding in investment certificates (\$5,835,000 for Bankers Thrift and \$3,056,000 for Universal). If all goes according to the approved bankruptcy plan, the investors could receive about \$8 million in payments over the next two years.

Under the plan of liquidation approved by the U.S. Bankruptcy Court, investment certificate holders will receive payments in three phases. Allowed administrative expenses (such as attorneys' and accountants' fees) will be paid or reserved before payments are made to certificate holders. Claims for \$250 or less will be paid in full before any payments are made to the other certificate holders. As of the first week of November 1992, a couple of issues had yet to be resolved before the first distribution could begin. Distributions will be computed separately for Bankers Thrift and Universal certificate holders.

Phase 1 — Bankruptcy trustees will make the initial, pro-rata distribution of all cash held by Bankers Thrift and Universal. The amount available is about \$5.7 million (\$3.7 million for Bankers Thrift, \$2 million for Universal). Bankers Thrift certificate holders should all receive about 63 percent of the amount of their certificates, while Universal certificate holders would all get about 66 percent. This distribution is supposed to be made before the end of 1992.

Phase 2 — The Consumer Credit Commissioner will distribute the money in the Guaranty Fund to those certificate holders eligible for "protection" up to the \$10,000 limits set by State law. The amount available in the Guaranty Fund is about \$500,000. The Commissioner will have to estimate the amount that will become available in Phase 3, and apply that to each account, to ensure that no one receives more than the amount "protected" under the \$10,000 limits. The Phase 2 distribution is supposed to be made within 45 days after Phase 1 is completed.

Phase 3 — The bankruptcy trustees will make periodic payments as the assets (mainly consumer loans) are converted into cash over the next two years. According to assumptions made by the current Consumer Credit Commissioner (who is one of the bankruptcy trustees), the total amount expected to become available in Phase 3 is \$1.8 million (\$1.2 million for Bankers Thrift, \$600,000 for Universal). All certificate holders should receive about 20 percent of the amount of their certificates in this phase. Phase 3 is the area of greatest uncertainty, because it involves liquidation of all the non-liquid assets, primarily consumer loans.

Payments in Phase 1 and Phase 3 will be made to all certificate holders, without regard to the \$10,000 guarantee applicable in Phase 2. Therefore, a person with a \$100,000 certificate would likely receive at least \$80,000 in Phases 1 and 3 combined.

The total of the payments in all three phases is \$8 million, or about 90 percent of the \$8,891,000 in outstanding certificates. The current Commissioner estimates that a Bankers Thrift investor with a \$10,000 account might receive slightly less than 90 percent, while a similar Universal investor would receive slightly more than 90 percent.

Under the assumptions laid out above, the "shortfall" between the amount paid and the amount eligible for coverage under the \$10,000 protection would be about \$500,000. This is the amount that the State might be asked to cover through the Special Claims process. This amount could go up, depending on the validity of assumptions for Phase 3 and the potential for disputes over the amounts eligible for the \$10,000 protection in Phase 2.

In a letter dated April 3, 1992, Attorney General Robert Stephan indicated the State may not have a legal responsibility to the victims of the failure of Bankers Thrift, but he thought the State had a moral duty to meet the terms of State-created guarantees on which people relied. He also indicated he would support payment of claims made by investors through the Joint Committee on Claims Against the State, at least up to the \$10,000 limits stated in the law.

As of early November 1992, more than 900 claims had been filed by investors of Bankers Thrift and Universal. It is not clear when the Joint Committee on Claims Against the State will consider the issues raised by the claimants. Uncertainty about the amount of money that can be raised in Phase 3 (collecting or selling off consumer loan obligations) could cause the Joint Committee to wait until after the 1993 legislative session.

Conclusion

The problems that culminated in the bankruptcy of Bankers Thrift and Loan were not the result of a faulty regulatory system. Those problems arose and grew because Consumer Credit Commissioners over the years failed to aggressively enforce the rules that had been put in place to protect the investing public from financial harm. Although it was clear for extended periods that some investment companies were not operating in compliance with State laws and regulations, Commissioners allowed those violations to go uncorrected. After \$1 million from the Guaranty Fund was used to buy some of Prudential's bad loans, officials in the Commissioner's Office should have known that the two remaining companies could not support the Guaranty Fund and keep it viable as protection for the public. Nevertheless, no one brought these issues before the Legislature or took other action to protect those who had purchased investment certificates or those who were considering such investments.

In the end, the Guaranty Corporation was dominated by the investment certificate industry, and actions taken by the Commissioner's Office appeared to have been more concerned with supporting the industry than protecting the depositors.

In the period of time covered by this audit, the Consumer Credit Commissioners' regulation of investment certificate companies was often characterized by inadequate documentation and inadequate followup to see that identified problems were corrected. While we did not review the other responsibilities of the Consumer Credit Commissioner's Office -- its oversight of finance companies and businesses that sell to consumers on credit -- we would hope that the kinds of problems noted in this report can be avoided or corrected in future operations of the Consumer Credit Commissioner's Office.

Recommendation

To ensure that the kinds of regulatory weaknesses and problems detailed in this report are not continued or repeated, the Consumer Credit Commissioner should review all aspects of the Office's current operations -- particularly those related to correcting problems noted in examinations. This review should determine whether changes are needed in State laws, State regulations, or internal procedures. As needed, the Commissioner should convey any recommended changes to the Governor and the appropriate committees of the Legislature.

APPENDIX A

Ten Additional Questions Raised about Prudential Loan and Investment Association and Bankers Thrift and Loan Company

When this audit request was approved by the Legislative Post Audit Committee, we were asked to seek answers to the following ten questions that were not a part of the approved scope statement. The following list provides answers to the additional questions, or refers to the pages in the report dealing with the issues.

1. *Why did the State allow Prudential Loan to hide delinquencies by rolling over loans and using balloon payments at the end?*

This issue is discussed on page 12 of the audit. The former Commissioner told us she thought she couldn't do much about this practice as long as Prudential stayed within the required financial ratios. In addition, she said that rolling over the loans was a way to keep people in business at a time when the economy in the Hays area was bad.

2. *What was the involvement of Commissioner Judy Bravence-Stringer surrounding the circumstances of the subordinated debenture?*

This question is discussed in the box on page 15 of the audit.

3. *Who approved the purchase of Prudential Loan to Roger Worden?*

Both the Commissioner and the Guaranty Corporation approved the purchase. The real power was in the hands of Commissioner Judy Bravence-Stringer, who had to approve of any sale of Prudential and any use of moneys in the Guaranty Fund. The sale of Prudential to Bankers Thrift also had to have approval from the FDIC, which held most of Prudential's stock. This question is discussed more fully in the box on page 15 of the audit.

4. *Wasn't there a conflict of interest for Roger Worden to be on the Insurance Fund's Board of Directors and supervise that fund when he owned the only remaining investment firm in the State?*

The decisions and recommendations made by the Guaranty Corporation's Board of Directors could not have been implemented without approval of the Commissioner. Nevertheless, it appeared to be a conflict of interest for Roger Worden and the other Board members to vote on Bankers Thrift's acquisition of Prudential and Universal, and to approve the use of \$1 million in the Guaranty Fund to buy out Prudential's bad loans. The small number of Board members and the lack of any public representation on the Board added to the appearance of a conflict of interest.

5. *Why did the Kansas Investment Guaranty Corporation contribute \$1 million to buy out Prudential?*

In 1989, the goal of the Corporation Board and Commissioner Bravence-Stringer was to return Prudential to viability. Using the money in the Guaranty Fund was intended to wipe out most of Prudential's bad loans before Prudential was taken over by Bankers Thrift. The Corporation bought a total of \$1 million of Prudential's receivables, with an agreement that any amounts collected by Bankers Thrift on those loans would be split 50-50. Through September 1992, the Guaranty Corporation had received about \$47,000 under that agreement.

6. *Is it true that Neil Arasmith was vice-chairman of the committee that decided to develop the guarantee fund all the while knowing that the Morris Corporation said it would never work because it would not have enough money to cover all deposits?*

Neil Arasmith was vice-chairman of the Special Committee on Commercial and Financial Institutions, which held hearings after the 1980 legislative session and decided to recommend the type of guarantee fund requested by the Kansas Association of Finance Companies. According to the Special Committee's report, a representative of the Morris Plan asserted that "the dollar amount of the fund would be too small to handle any claim made against it in the first few years." On that basis, the Morris Plan official asked the Special Committee to reconsider how much protection was being given to consumers through the guarantee fund.

7. *Roger Worden says the \$300,000 common stock disappearance was due to a wrong entry. Was that proven?*

This question relates to a reduction in the value of shares of Bankers Thrift stock, which was required following an independent audit of Bankers Thrift in 1990. The reduction apparently raised questions in the Commissioner's Office, and those questions were mentioned in a legislative hearing in March 1992. The main events that led to the misunderstanding can be summarized as follows:

- Bankers Thrift and Prudential were merged at the end of 1989, after Bankers Thrift bought Prudential's stock. At that time, Bankers Thrift showed \$350,000 of common stock (at \$1 per share) on its balance sheet. Prudential's last quarterly report for 1989 showed common stock valued at \$512,000, despite the fact that its stock had been sold to Bankers Thrift for \$1.

- On its first quarterly report of 1990, Bankers Thrift showed \$1,112,700 of common stock (at \$1 per share) on its balance sheet. This entry appeared to be in error; even if the \$350,000 and \$512,000 (as shown above) were added together, the total of common stock would have been only \$867,000.

- When the certified public accountants did the 1989 audit of Bankers Thrift, they required adjustments to bring Bankers Thrift's common stock back down to the original level of \$350,000. Those adjustments, totaling \$762,000, were shown as a "common stock reduction" on the second quarterly report in 1990.

- The third and fourth quarterly reports for 1990 continued to show the \$762,000 common stock reduction, which apparently led to the mistaken impression that stock had been sold or redeemed during 1990.

8. *Why wasn't Prudential shut down and liquidated when both Mel Battin and (later) Bill Caton agreed that depositors would have virtually recovered all of their deposits at that time?*

Former Commissioner Bravence-Stringer told us that if Prudential had been liquidated, many investors would have lost money. At a minimum, the people who had invested more than \$10,000 would have incurred a loss. According to the former Commissioner, Assistant Commissioner Mel Battin never indicated to her that he thought Prudential should be liquidated. Mr. Battin did write a memo to the Commissioner on July 25, 1989, suggesting that she immediately take possession of Prudential if the bids from finance companies (to purchase Prudential's receivables) were not adequate to fully pay off all certificate holders. Mr. Battin wrote another memo (undated and unsigned) in early September 1989, indicating that liquidation of Prudential was the best option. Mr. Battin's memo said "whatever is going to happen eventually should happen immediately, that is liquidate the company." Mr. Battin estimated that immediate liquidation of Prudential would require payments of about \$537,000 from the Guaranty Fund, leaving a "sufficient" balance of about \$780,000 to cover the other two companies (Bankers Thrift and Universal). Ms. Bravence-Stringer (now Ms. Kinard) told us she did not recall seeing this memo, and that Mr. Battin never indicated to her that he thought Prudential should be liquidated.

9. *Because the Guaranty Corporation had a net worth of only \$493,259, far short of what was needed to insure certificates, why did the State mandate that the certificates of deposit advertise this coverage?*

On each certificate sold, State law mandated the language about a single investor being protected up to a maximum of \$10,000 by the Kansas Investment Certificate Guaranty Fund. Neither Commissioner Bravence-Stringer (whose term expired in January 1990) nor Commissioner Arasmith sought any change in the statutory language, even after more than two-thirds of the Guaranty Fund had been used to buy bad loans from Prudential. As pointed out at page 9 of the report, there was no legal requirement for anyone to determine whether the Fund's balance was adequate to support its potential obligations.

10. *Roger Worden stated in July 1991 that investors could only recover 25 to 30 percent of their deposits, should the State liquidate his company. Why has that figure changed so dramatically since then?*

In a July 22, 1991, letter to all investors, Roger Worden stated "We believe that if the State liquidated Bankers Thrift and Universal, there would be a potential recovery of only 25 to 30 percent of your investment certificates." Mr. Worden did not explain how this range was arrived at. From records on file at the bankruptcy court, it appears that the liquid assets of Bankers Thrift and Universal should enable investors to receive at least 60 percent of their investments back in the first distribution. When the July 1991 letter was written, Roger Worden was hoping to avoid liquidation of Bankers Thrift. Therefore, underestimation of the liquidation value of Bankers Thrift would have supported the idea of reorganization -- rather than liquidation -- of Bankers Thrift.

APPENDIX B

Events Concerning the Investment Certificate Industry And the Failure of Bankers Thrift and Loan Company

The following individuals were involved with the investment certificate industry and are mentioned in the sequence of events between 1985 and 1992.

Consumer Credit Commissioners:

Don Phelps, January 1982 to January 1986, appointed by Governor Carlin
Judy Bravence-Stringer, January 1986 to January 1990, appointed by Governor Carlin
Neil Arasmith, February 1990 to September 1991, appointed by Governor Hayden
Bill Caton, September 1991 to present, appointed by Governor Finney

Mel Battin, Assistant Consumer Credit Commissioner, May 1979 to present

Board of Directors and Officers of the Kansas Investment Certificate Guaranty Corporation:

Roger Worden, Bankers Thrift and Loan Company
Irvin Karlin, Prudential Loan and Investment Association
James Rhine, Universal Financial Services
Arthur Barrett, Bankers Thrift and Loan Company
Stan Lind, Attorney and Secretary for the Corporation

Other Individuals Mentioned:

Don Nipple, Prudential Loan and Investment Association (loan officer, later president)
Joe Karlin, Prudential Loan and Investment Association (vice president and manager)

Sequence of Events Between 1985 and 1992

1985

Nov. 12, 1985 The Guaranty Corporation's bylaws were changed to allow each investment company to have a member on the Board of Directors (one-fourth of all members, or at least two, should be public members).

1986

Jan. 1986 Judy Bravence-Stringer took office as Consumer Credit Commissioner, replacing Don Phelps.

Aug. 1986 Only three companies remained as members of the Guaranty Corporation (Bankers Thrift - Leawood, Prudential - Hays, and Universal - Manhattan). Directors said they needed to reassess the Corporation's status and future operations in view of the present membership.

Oct. 21, 1986 The Guaranty Corporation Board members discussed (in San Francisco) alternatives for the Corporation's future. It was decided that the Corporation should continue in its present function.

1987

June 11, 1987 The Corporation could no longer obtain liability insurance for officers and directors. Because they were no longer insured, the two public members of the Board resigned immediately.

August 1987 A directors' and officers' liability policy was found that could be obtained for \$25,000 a year. The Guaranty Corporation Board members determined the expense to be prohibitive.

Sept. 14, 1987 The Guaranty Corporation gave its approval (subject to the Consumer Credit Commissioner's approval) for the sale of Bankers Thrift to BTLA Holding Company (owned by Roger Worden, President of Bankers Thrift).

Sept. 30, 1987 Prudential ended its fiscal year with a net loss of \$271,870.

1988

Jan. 21, 1988 In order to maintain compliance with minimum capital requirements, Prudential issued 414 shares of common stock at \$145 per share, for a total of \$60,030 in new capital. After this transaction, First of Kansas Financial Corporation owned 92 percent of Prudential's stock.

Feb. 25, 1988 Guaranty Corporation Audit Committee Meeting
Prudential added \$60,030 of paid-in capital to put the company in compliance with capital requirements. The Committee members said that they would monitor the delinquency ratios.

Apr. 30, 1988 Bankers Thrift ended its fiscal year with a net loss of \$18,450.

May 11, 1988 Guaranty Corporation Audit Committee Meeting
Prudential, after drastic writeoffs, reportedly should net \$54,000 for the first six months of its fiscal year.
Bankers Thrift showed an income of \$36,000 in its fiscal year (ending in April) 1988. Its quarterly report showed a loss.

Sept. 30, 1988 Prudential ended its fiscal year with a net loss of \$358,471.

Nov. 22, 1988 The Consumer Credit Commissioner's Office completed its 1988 examination of Prudential, which showed a loan delinquency rate of nearly eight percent, well above the five percent maximum established in State regulations. The examination also showed that Prudential had issued a higher amount of investment certificates than allowed by law, in relation to its net worth.

Nov. 28, 1988 Assistant Commissioner Battin wrote a memo to Commissioner Bravence-Stringer, concerning the alternatives available to address Prudential's problems with delinquent loans. Mr. Battin did not recommend suspending Prudential's authority to issue investment certificates, because that

could case a "run" that would bankrupt Prudential and cause losses to investors. The memo did suggest that Prudential would be willing to send a letter, advising how the delinquent loans would be collected or charged off. A note in the file said the Commissioner spoke with Irvin Karlin of Prudential, and requested a proposal for collection of the delinquency.

1989

- Jan. 11, 1989 An internal memorandum from Assistant Commissioner Mel Battin to Commissioner Judy Bravence-Stringer said that Prudential's problem was that the stockholders' equity would not support the amount of certificates outstanding. The memo said that having the Guaranty Corporation loan money to Prudential would not help, and that the only remedy was for Prudential to increase stockholders' equity through the sale of stock.
- Feb. 9, 1989 Commissioner Bravence-Stringer sent a letter to Attorney General Robert Stephan, concerning the fact that Prudential's capital was impaired. The letter requested legal advice about the procedures to be followed if the Commissioner decided to take possession of all Prudential assets.
- Feb. 15, 1989 Guaranty Corporation Audit Committee Meeting
Prudential lost \$404,000 and had drastic writeoffs in 1988. It also lost an additional \$20,000 in January 1989. (Irvin Karlin said that Prudential would return to profitability in February.)
Roger Worden was negotiating to purchase the parent company of Prudential (First of Kansas Capital Corporation, of Hays).
- Feb. 15, 1989 Prudential's capital ratio was out of compliance.
- April 7, 1989 FDIC took over First of Kansas Financial Corporation (Prudential's parent company) and Prudential. FDIC had control of 92 percent of Prudential's stock. Prudential had serious financial problems, but the Board of the Guaranty Corporation thought that the sale of the assets would not cover the investment certificates.
Roger Worden said he would try again to buy the First of Kansas Financial Corporation through the FDIC bid list, but that would take six months.
- April-May 1989 Numerous phone calls were made about the future of Prudential. According to Stan Lind, the matter was at a standstill because the intentions of the FDIC and the Schwaller family (owners of First of Kansas Financial Corporation) could not be ascertained.
- May 18, 1989 Guaranty Corporation Audit Committee Meeting
Prudential continued to be out of compliance with the required financial ratios.
- May 22, 1989 Bankers Thrift made a written offer (to the FDIC and Commissioner Bravence-Stringer) to purchase Prudential. In June, the FDIC rejected the bid.
- June 5, 1989 Deines and Stout (of Woodbine, KS) made an offer to purchase Prudential.
- June 7, 1989 The Board of Directors reviewed the three bids made to purchase Prudential: Roger Worden; Stout and Deines, Inc.; and Don Nipple. The Guaranty Corporation Board resolved to ask the FDIC for permission to "spread the receivables" for those who were interested in bidding on Prudential.

- July 5, 1989 The Board considered an offer by Stout and Deines, Inc. (representing another investor) to buy Prudential for a dollar, inject \$50,000 in new capital, and borrow \$500,000 from the Guaranty Fund. The Board decided to give no further consideration to the offer of Stout and Deines, because Stout and Deines declined to increase its capital contribution to \$400,000. The FDIC manager stated he was still awaiting word from his superiors as to the sale of Prudential stock. The proposal made by Don Nipple and Irvin Karlin (not in written form) was not considered because it was contingent on the FDIC repurchasing real estate contracts from Prudential.
- July 12, 1989 Stan Lind was advised that the FDIC manager had received authority to sell the Prudential stock.
- July 21, 1989 The Commissioner met with Roger Worden and James Rhine to review the results of the grading of the Prudential accounts. The Commissioner's examiners concluded that there was a total of \$1 million of bad debt to be written off. The FDIC manager reportedly concurred in this estimate.
- July 25, 1989 An internal memorandum from Assistant Commissioner Mel Battin to Commissioner Judy Bravence-Stringer recommended that if the bids to purchase Prudential's receivables (along with moneys in the Guaranty Fund) were not adequate to pay off all certificate holders in full, the Commissioner should immediately take possession of Prudential and appoint the Guaranty Fund as receiver.
- July 25, 1989 The Guaranty Corporation Board considered options related to Prudential, including:
(1) accepting the Nipple and Karlin proposal
(2) having the Guaranty Corporation purchase the Prudential stock and hire Don Nipple to operate the company
(3) seeking bids from several finance companies to purchase Prudential's accounts receivable
- Aug. 11, 1989 Avco Financial Services of Irvine, California, submitted a written offer to purchase about \$5.5 million of Prudential's receivables for \$2.2 million.
- Aug. 28, 1989 Security Pacific Financial Services, of San Diego, submitted a written offer to purchase about \$5.1 million of Prudential's receivables for \$2.47 million, plus 50 percent of the cash collected over the next three years on about \$1.8 million of "non-value receivables."
- Aug. 28, 1989 According to Stan Lind, Commissioner Bravence-Stringer told him she had decided that Prudential should be sold to Don Nipple under these terms:
(1) The Guaranty Corporation would loan Don Nipple \$750,000 by way of a five-year subordinated debenture.
(2) For five years the debenture would carry no interest nor require any principal repayments, it would be renegotiated after that time.
(3) \$900,000 in uncollectible accounts would be charged off.
(4) The loan would be contingent on getting one investor to agree to convert his certificates into a subordinated debenture or preferred stock.

- Aug. 29, 1989 Guaranty Corporation Audit Committee Meeting
Bankers Thrift showed a profit of \$37,732 in fiscal year 1989 (ending in April). In May and June, Bankers Thrift lost \$35,737.
- Aug. 29, 1989 Guaranty Corporation Board Meeting
The Board decided that it was not a good idea to sell Prudential's assets to Don Nipple, as the Commissioner had indicated on August 28. An alternative plan was recommended to the Commissioner, under which the Guaranty Corporation would buy Prudential's stock from FDIC for \$1. The other terms of this plan included:
- (1) infusing \$750,000 of Guaranty Corporation moneys into common stock of Prudential
 - (2) permitting Don Nipple to purchase the insurance agency (another subsidiary of First of Kansas Capital Corporation) from FDIC for \$10,000
 - (3) retaining Mr. Nipple as the managing officer of Prudential, with stock options as an incentive
 - (4) requiring extensive amendments to Prudential's by-laws
 - (5) getting one investor to agree to convert \$275,000 of his certificates into a subordinated debenture or preferred stock.
- September 1989 An undated internal memorandum from Assistant Commissioner Mel Battin indicated his opposition to allowing the Guaranty Corporation to buy \$1 million in bad loans from Prudential. Mr. Battin's memo recommended closing Prudential and liquidating it, saying "whatever is going to happen eventually should happen immediately." Mr. Battin estimated that immediate liquidation of Prudential would require payments of about \$537,000 from the Guaranty Fund, leaving a "sufficient" balance of about \$780,000 to cover the other two companies (Bankers Thrift and Universal). The memo also said that if the Guaranty Corporation spent \$750,000 to \$1 million to acquire bad loans from Prudential, the Guaranty Fund would be depleted. [Mr. Battin's memo was undated and unsigned. Judy Bravence-Stringer (now Judy Kinard) says she never saw this memo, nor did Mr. Battin ever recommend liquidating Prudential.]
- Sept. 18, 1989 After a long discussion, Commissioner Bravence-Stringer decided she could not approve the proposal for the Guaranty Corporation to buy Prudential's stock and have Don Nipple manage Prudential, because Don Nipple had no resources to operate it if matters did not develop as planned. According to Stan Lind, Commissioner Bravence-Stringer said the best course of action would be to liquidate Prudential. Roger Worden then asked the Commissioner if she would approve the sale of Prudential to Bankers Thrift. The Commissioner reportedly replied that she would approve such a purchase.
Roger Worden then stated that if James Rhine would agree to sell Universal to Bankers Thrift, Worden would place a bid with FDIC to purchase Prudential. Rhine said he would submit the question to the Universal board of directors, so the status of Prudential was placed on hold until that was resolved.
- Oct. 1, 1989 Bankers Thrift purchased all the common stock of Universal Financial Services, Inc.

- Oct. 5, 1989 In a letter to the managing agent of First of Kansas Financial Corporation, Commissioner Bravence-Stringer advised that she had given authority for Bankers Thrift to purchase the stock of Prudential.
- Oct. 30, 1989 In a letter to Roger Worden, Commissioner Bravence-Stringer authorized Bankers Thrift to acquire Universal Financial Services, Inc.
- Nov. 1, 1989 The Guaranty Corporation Board approved the sale of Universal Financial Services to Bankers Thrift. The Board also approved the sale of Prudential to Bankers Thrift. Irvin Karlin (Prudential) resigned from the Board, so there were two members left.
- Nov. 3, 1989 The Board discussed the details of the Prudential purchase by Bankers Thrift. The Board decided that if Prudential obtained the conversion of \$275,000 of certificates into subordinated debentures, the Guaranty Corporation would:
- (1) immediately purchase \$750,000 of charged-off accounts from Prudential.
 - (2) purchase an additional \$250,000 of charged-off accounts within one year.
 - (3) enter into a collection agreement so that 50 percent of the amounts collected would go to the Guaranty Corporation.
- The Board approved the purchase of 92 percent of Prudential's stock by Bankers Thrift or by the First Kansas Capital Corporation.
- Nov. 3, 1989 The FDIC approved the sale of Prudential to Bankers Thrift for \$1.
- Nov. 28, 1989 The sale of Prudential to Bankers Thrift became final.
- Dec. 4, 1989 Commissioner Bravence-Stringer gave written approval for the Guaranty Corporation to purchase \$750,000 of accounts receivable from Prudential.
- Dec. 14, 1989 The Guaranty Corporation Board discussed details of the Corporation's initial purchase of \$750,000 in accounts receivable from Prudential.
- Dec. 31, 1989 Prudential was merged into Bankers Thrift and Loan Association. The audit report for 1989 showed that Bankers Thrift had issued about \$7,918,000 in outstanding investment certificates and Universal had issued about \$2,136,000 in investment certificates, for a total of nearly \$10,054,000.

1990

- Jan. 20, 1990 The term of Consumer Credit Commissioner Judy Bravence-Stringer expired. The new Commissioner was Neil Arasmith.
- Feb. 27, 1990 Guaranty Corporation Audit Committee Meeting
(Commissioner Arasmith was present for the first time.)
Prudential was still having delinquency problems. Don Nipple, president of Prudential, had resigned Feb. 20. He was replaced by Joe Karlin. The accounts were in bad shape, and delinquency on 90-day accounts apparently was at least 23 percent. Art Barrett estimated another \$500,000 needed to be charged off.
Bankers Thrift moved its Manhattan branch office to the same location as the Universal Financial Services office, in order to reduce overhead cost.
Meeting minutes stated that Bankers Thrift purchased Prudential to save the

Guaranty Corporation and protect the public against loss. Universal Finance Services was purchased to help produce additional income while Prudential's problems were being corrected.

Bankers Thrift had decided to close its Topeka and Salina offices.

Commissioner Arasmith said that his office would work with Bankers Thrift until Bankers Thrift gets the (Prudential) delinquency problems under control.

- April 5, 1990 The independent auditors' report on Bankers Thrift (including Prudential and Universal) for 1989 had no adverse findings except for the fact that the amount of delinquent loans exceeded the five percent requirement established by State regulations.
- May 22, 1990 Commissioner Arasmith gave written approval for the Guaranty Corporation to purchase an additional \$121,693 of accounts receivable from Prudential, leaving a balance of \$128,307 payable from the original \$1 million commitment.
- Nov. 27, 1990 Guaranty Corporation Audit Committee Meeting
Bankers Thrift was still out of compliance with financial ratios.
Universal Services was in compliance but has a receivable due from the parent company (Bankers Thrift) for \$2,029,392 (non-interest bearing note). It was thought that Bankers Thrift's ability to pay that note was questionable.
- Nov. 27, 1990 Consumer Credit Commissioner and Bankers Thrift Meeting
Bankers Thrift & Universal have \$8.6 million in certificates but only \$7.5 million in assets (\$1.1 million short). According to Roger Worden's calculations, the operation could break even in two years.
The Consumer Credit Commissioner did not make any decisions on how to proceed. He was waiting for financial statements.
- Dec. 20, 1990 Consumer Credit Commissioner and Bankers Thrift Meeting
Liquidation of Bankers Thrift and Universal was discussed. The consensus was that more dollars could be collected over a period of two to three years.

1991

- Feb. 26, 1991 Consumer Credit Commissioner and Bankers Thrift Meeting
Universal was in compliance with required financial ratios. Bankers Thrift was out of compliance with capitalization and delinquency ratios.
- Mar. 29, 1991 The 1990 independent CPA audit of Bankers Thrift gave an adverse opinion on the company's financial statements and included the following findings:
-- the company had recorded insufficient provision and allowance for uncollectible loan receivables.
-- the \$275,000 debenture shown as stockholders' equity should have been counted as a liability.
-- the company had a net loss of almost \$665,000 in fiscal year 1990.
-- the company had suffered recurring losses from operations and had a net capital deficiency that raised substantial doubt about its ability to continue as a going concern.
- May 9, 1991 The Consumer Credit Commissioner's Office received a copy of the 1990 CPA audit of Bankers Thrift.

- May 14, 1991 Guaranty Corporation Audit Committee Meeting
Bankers and Universal were out of compliance with their financial ratios. It was the general consensus that steps should be taken to liquidate both companies. The Consumer Credit Commissioner gave Roger Worden one week to try to sell the receivables in the Bankers Thrift Hays office and the Universal office in Manhattan.
- May 17, 1991 Mel Battin, Assistant Consumer Credit Commissioner, sent a letter to the Attorney General's Office, explaining that Bankers Thrift had a negative balance in its capital account, in violation of K.S.A. 16-601a. The letter also noted that Universal Financial Services also had a negative net worth.
- May 22, 1991 Stan Lind sent to Commissioner Arasmith draft orders concerning the steps needed for the Commissioner to take possession of Bankers Thrift. The first order would have made the official finding that the capital of Bankers Thrift was impaired, and would have given Bankers Thrift an unspecified number of days to sell accounts receivables that originated in the Hays office. A handwritten note on the first order indicated that if the Commissioner found that it was no longer safe for Bankers Thrift to conduct business, then "instant action" was needed. The second order would have been issued when the Commissioner actually took possession of all assets of Bankers Thrift and Universal.
- May 30, 1991 Commissioner Arasmith sent a letter to Governor Finney, advising her that Bankers Thrift and Universal were insolvent, and that the institutions would be placed in receivership on June 4.
- June 4, 1991 The Consumer Credit Commissioner required Bankers Thrift and Universal to close their offices, because Commissioner Arasmith found that they were operating in an unsafe or unsound condition and they were not in compliance with capital requirements set by law. The order issued by Commissioner Arasmith allowed the Commissioner to take possession of the property and business of Bankers Thrift and Universal for a period of 10 days (until a hearing was to be held) and suspended payment on all liabilities. Sometime shortly after June 4, Commissioner Arasmith sent a letter to all certificate holders, explaining why Bankers Thrift and Universal had been closed, and that a decision on liquidating them would be made within two weeks.
- June 19, 1991 Bankers Thrift filed for bankruptcy in the United States Bankruptcy Court for the District of Kansas.
- July 22, 1991 Roger Worden sent a letter to all certificate holders of Bankers Thrift and Universal, explaining what led up to the closing of the two companies and their filing for bankruptcy. The letter indicated that filing for bankruptcy was preferable to the other two alternatives -- injecting \$550,000 into their capital structure or allowing the State to take over the companies and liquidate them. The letter said "We believe that if the State liquidated Bankers Thrift and Universal, there would be a potential recovery of only 25 to 30 percent of your investment certificates."

- Sept. 12, 1991 Representative Delbert Gross and Senator Jerry Moran sent a letter to Attorney General Robert Stephan, requesting an opinion regarding any liability the State of Kansas might have to the investment certificate holders of Bankers Thrift.
- Sept. 20, 1991 In a letter to Representative Gross and Senator Moran, the Attorney General declined to give an opinion because the issues could be raised in litigation over this matter. As attorney for the State, the Attorney General did not want to compromise the State's position by rendering an advance opinion. The letter did point out sections of the Tort Claims Act that could be relevant to this situation.
- Sept. 1991 Neil Arasmith left the position of Consumer Credit Commissioner. The new Commissioner was Bill Caton.

1992

- Feb. 4, 1992 The Guaranty Corporation hired a bankruptcy attorney to study the joint plan of reorganization for Bankers Thrift and Universal Financial Services. The Consumer Credit Commissioner said that his office would do the annual audit of these companies instead of hiring an independent CPA.
- April 3, 1992 In a letter to Senator Jerry Moran and Representative Delbert Gross, Attorney General Robert Stephan said the State may not have a legal responsibility to the victims of the failure of Bankers Thrift, but the State had a moral duty to meet the terms of State-created guarantees on which people relied. Therefore, he indicated he would support making these investors whole (through the Joint Committee on Claims Against the State), at least up to the \$10,000 limit stated in the law.
- May 4, 1992 An amended Plan of Reorganization was filed in the U.S. Bankruptcy Court by Bankers Thrift and Loan Association. This plan would have allowed Bankers Thrift to continue in operation. This plan was later rejected by vote of the certificate holders.
- Aug. 7, 1992 A joint Plan of Liquidation was filed by the official unsecured creditors committees of Bankers Thrift and Universal. The certificate holders were to vote on approval or disapproval of this plan by September 2, 1992.
- Sept. 11, 1992 The Plan of Liquidation presented by the creditors committees of Bankers Thrift and Universal was confirmed by the U.S. Bankruptcy Court. The written order of confirmation was filed on September 23.

APPENDIX C

The Regulation of Financial Institutions in Kansas

The following table summarizes some of the key elements concerning the regulation of financial institutions and the guarantee of accounts in those institutions.

	<u>Investment Certificates Companies</u>	<u>Savings and Loans</u>	<u>Credit Unions</u>	<u>Banks</u>
State Agency	Consumer Credit Commissioner's Office	Savings and Loan Dept.	Dept. of Credit Unions	Banking Dept.
Accounts Guaranteed by:	Private Organization	FDIC (a)(c) Federal Govt.	NCUA (b) Federal Govt.	FDIC (a) Federal Govt.
Guarantee	\$10,000	\$100,000	\$100,000	\$100,000
Audits and Examinations Required	An annual CPA audit is required for all types of financial institutions.			
	12-Month Examination	12-Month Examination	14-Month Examination	18-Month Examination

As the chart shows, investment certificate companies were the only ones that guaranteed their investors' funds through a private organization rather than through an agency of the federal government. The amount in the private fund was limited to the assessments made on investment certificate companies, while the other funds were backed by the federal government.

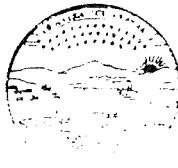
The source of regulation for each type of financial institution also varied. Regulatory authority for investment certificate companies came from State law, and examinations were done by the Consumer Credit Commissioner's office. Regulations for other Kansas financial institutions that we reviewed came from federal requirements. Examinations of banks and credit unions were usually done by the appropriate State agency, and examinations of savings and loans were usually done by the federal Office of Thrift Supervision.

- (a) FDIC - Federal Deposit Insurance Corporation
- (b) NCUA - National Credit Union Association
- (c) The Federal Savings and Loan Insurance Corporation, which formerly insured deposits in savings and loans, was merged into the Federal Deposit Insurance Corporation about two years ago.

Appendix D

Agency Response

On November 12, we provided copies of the draft audit report to the Consumer Credit Commissioner. The Commissioner's response is included as this Appendix.



KANSAS

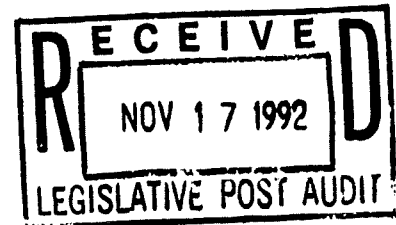
Office of CONSUMER CREDIT COMMISSIONER

Joan Finney
Governor

Wm. F. Caton
Commissioner

November 17, 1992

Barbara Hinton
Legislative Post Auditor
Merchants Bank Tower
800 SW Jackson, Ste 1200
Topeka, Kansas 66612-2212



Dear Ms. Hinton:

Thank you for the opportunity to review and respond to the performance audit of the Consumer Credit Commissioner in regard to the regulation of investment certificate companies. Your staff performed in a very professional manner and spent a lot of time and effort outside "business hours" to collect information important in understanding the situation.

I feel I am privileged in two ways in reflecting on the past decisions that were made in this situation. First, hindsight always seems to be more accurate because we can reflect on the known consequences of decisions that were made. Those individuals who made those decisions did not have the luxury of hindsight. Secondly, my banking background allows me to have a somewhat different perspective in regard to understanding the concept of insuring deposits.

Your report is accurate as to the facts surrounding the events leading to the present day situation. I also agree that past regulation of the industry was lacking in documentation and sufficient procedures to properly address the gravity of the task. I would like to share my perception of some important and pertinent facts not addressed by your report that I feel have a significant impact on the events that have taken place.

I strongly believe that no one, including the Legislature that passed the original legislation, ever considered what would happen if the investment certificate industry would ever dwindle to the state it was in prior to its collapse. Would this have possibly made a difference in the form of legislation had this been addressed?

The policies and procedures used by the Consumer Credit Commissioner to oversee this industry appear to me to have failed in acknowledging the fact that liquidation of assets might be the source of paying back investors. Current status of the loans appeared to have more significance than the quality of the loans.

46 of 2

Ms. Hinton
November 17, 1992
Page two

These procedures did not change as the industry changed. I can attest that the banking regulators, both state and federal, responded to the deteriorating banking industry with policies and procedures that addressed the changing conditions. I believe that this is a direct reflection of the past Commissioners' lack of understanding of asset management and risk assessment from an insurer's or guarantor's point of view. I do not mean this derogatorily; only that this concept was outside their experience and knowledge.

Also, the original legislation was never intended to be an extension of security for the investor. It was legislation "by the industry, for the industry" and to be overseen by the industry. The industry desired the ability to compete for insured deposits of depository institutions. Without the security of some sort of guaranty, this would not be possible. The investment certificate industry's motive was to decrease their cost of funds by attracting private funds rather than loans from financial institutions. The high rates of the late seventies and early eighties made private funds less expensive and insured deposits of other financial institutions competed with investment certificates. This is substantiated by the mass exit of investment certificate companies in the mid eighties when interest rates declined and traditional bank lines of credit were more affordable than maintaining a deposit base of investment certificates.

Although the Guaranty Corporation and regulation of the investment certificate industry were statutorily under the control of the Commissioner, there was a deficiency that I feel had a tremendous impact on the situation. Unlike the other financial regulators, the Consumer Credit Commissioner did not have a board to help make the tough decisions that needed to be made. The basic duty of a regulatory board is to advise the administrator in policy decisions. These policy decisions would definitely include updating procedures and assessing the health of individual companies as well as the industry as a whole. Although a board would not be making decisions as to whether or not to close an institution they would be available in an advisory capacity to at least let the Commissioner know if his decisions were proper and supported. I believe that this situation is the single largest contributor to the lack of action on the part of the Commissioner when changes and decisions were necessary. The gravity of a decision that has the impact of closing a financial institution is tremendous and should not be put on the shoulders of one person, at least without the opportunity to get feedback from a board.

I feel that the staff of the Consumer Credit Commissioner did their jobs adequately and professionally. The responsibility of policy and decision making rests solely on the Commissioner. The responsibility of regulating a deposit base industry is an extremely large responsibility, especially if their experience and qualifications are limited in area.

Ms. Hinton
November 17, 1992
Page three

The statutory qualifications require only three years experience managing a consumer loan company which has no reference to an investment certificate company.

The report addresses the unsuccessful attempt to avoid closing Prudential by the Guaranty Fund purchasing \$1 million in problem loans. Although this was unsuccessful, I do not believe that the money has been lost. The present company (Bankers Thrift) would have \$1 million less in cash and \$1 million more in consumer loans. It could be argued that the money is still intact since the company has maintained cash balances well above \$1 million. Also, this strategy of purchasing non-performing assets was also used by the other financial regulators, and it was both successful and unsuccessful in different instances. The report also downplays the role of the FDIC in this situation. The inability to negotiate the sale of Prudential for several months contributed to the deterioration of the loan portfolio due to the apparent lack of collection efforts.

I somewhat disagree with the report's conclusion that the statutory arrangement for regulating investment certificate companies is adequate. I feel the statutes failed to address the following:

1. The statutes did not provide a regulatory board for the Commissioner to rely on in developing policy and making difficult decisions.
2. The statutes did not prohibit investment certificate companies from seeking protection under bankruptcy laws as other financial institutions that have insurance or guarantee backing. The statutes relating to the liquidation of assets by the Commissioner to facilitate the return of the investors' money have been preempted by federal bankruptcy law and therefore are not enforceable.
3. The statutes should have required that the Commissioner should have some qualifications or experience in regulating a deposit based industry.
4. The statutes were designed to benefit the industry. This gave opportunity to provide a false sense of security to the investors.
5. The statutes did not require any reports to be provided to the Legislature about pertinent information on the industry or the Commissioners' success or failure in regulating this industry.

I suggest that if this same legislation was placed under a regulatory system similar to the State of Kansas Banking Department, there would have been completely different outcomes.

Ms. Hinton
November 17, 1992
Page four

The report is very critical of past Commissioners' forbearance towards Bankers Thrift. I believe that the Commissioners were acting with temperance similar to other financial regulators at that time. It is important to understand that this situation was not isolated to Kansas or to the investment certificate industry but that the entire financial industry was undergoing a severe crisis.

I would like to conclude by recommending a study of merging the State Banking Department and the Office of the Consumer Credit Commissioner after the conclusion of the bankruptcy liquidation of Bankers Thrift and Universal. Expansion of the Banking Board to include members from the consumer loan industry would insure that the industry have a voice in the regulatory decisions. The Office of the Consumer Credit Commissioner could function as a division of the State Banking Department and continue its regulatory responsibilities. The Banking Department would benefit from having in-house expertise of the Kansas Uniform Consumer Credit Code, which also affects the banking industry. It could also have some cost effectiveness.

I have a strong commitment to helping the investors in any way I can to recover their hard earned money. Governor Finney has expressed to me her support in my efforts and her concern that the State meets its regulatory responsibilities to these individuals.

My staff and I pledge to you our continued cooperation and will be available to your staff if there is a need for further investigation. Again, thank you for this opportunity to share my observations and conclusions.

Sincerely,



Wm. F. Caton
Commissioner

BEN E. VIDRICKSEN

SENATOR, DISTRICT 24
SALINE, ELLSWORTH,
LINCOLN COUNTIES
713 N. 11TH STREET
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(913) 827-4251
827-2551
827-5964
STATE CAPITOL
TOPEKA, KANSAS 66612-1565
(913) 296-7390



TOPEKA

SENATE CHAMBER

COMMITTEE ASSIGNMENTS

CHAIRMAN: LEGISLATIVE, JUDICIAL AND
CONGRESSIONAL APPORTIONMENT
VICE CHAIRMAN: LEGISLATIVE POST AUDIT
MEMBER: ECONOMIC DEVELOPMENT
FEDERAL AND STATE AFFAIRS
GOVERNMENTAL ORGANIZATION
PUBLIC HEALTH AND WELFARE
TRANSPORTATION AND UTILITIES
JOINT COMMITTEE ON STATE
BUILDING CONSTRUCTION
MEMBER: GOVERNOR'S COMMISSION ON TRAVEL
AND TOURISM
MEMBER: NATIONAL CONFERENCE OF STATE
LEGISLATURES

Assistant Majority Leader

November 24, 1992

Barbara J. Hinton
Legislative Post Auditor
800 SW Jackson, Suite 1200
Topeka, KS 66612

Dear Barb:

As you know, the Legislative Post Audit Committee met yesterday and received testimony about the performance audit, Reviewing State Regulation of Bankers Thrift and Loan Company. During the discussion, some Committee members said they thought the first sentence of the report's conclusion (on page 20) could be misleading in light of the problems described in the report and in later parts of the conclusion. Apparently the report's conclusion was based on looking at the design of the regulatory system separately from the implementation of the system. On that basis, the audit staff concluded the problems that culminated in the bankruptcy of Bankers Thrift were not the result of the way the regulatory system was designed, as much as the very poor way in which the regulation and oversight were carried out.

Committee members generally thought design and implementation of the regulatory system could be and perhaps should be viewed as a whole. From that viewpoint, the regulatory system failed to protect the depositors from financial harm even though the Consumer Credit Commissioners were aware of serious problems within the investment certificate companies.

The members of the Legislative Post Audit Committee did not want the report's conclusion to be misconstrued, so I am directing you to include a copy of this letter with any report distributed in the future. Anyone who has further questions about this matter should contact your office.

Sincerely,

Ben E. Vidricksen, Chairman
Legislative Post Audit Committee

5092

AN OVERVIEW
of the
KANSAS STATE DEPARTMENT OF CREDIT UNIONS
Wayne Warfel, Administrator

Presented to the
HOUSE COMMERCIAL, FINANCIAL INSTITUTIONS & INSURANCE COMMITTEE
Representative William Bryant, Chairman
January 19, 1993

*Financial Institutions &
Insurance*

*January 19, 1993
Attachment 3*

HOW CREDIT UNIONS DIFFER

Organization	Credit Union	Bank	Savings and Loan
Orientation or Purpose	Not-for-profit cooperative	Profit	Profit (except for mutuals)
Type of Business Organization	State or Federally chartered cooperative	State or Federally chartered corporation	State or Federally chartered corporation
Ownership	All members/users	Stockholders	Stockholders
Directors	Volunteers/no pay	Stipend	Stipend
Decision Making	Democratically controlled - one vote per member	One vote per stock unit	One vote per stock unit
Primary Source of Income	Consumer loans and investments	Business loans, customer fees and investments	Real estate and business loans, customers fees and investments
Distribution of Net Income	Dividends to members and capital development	Dividends to Stockholders	Dividends to Stockholders
Services Offered	Consumer Services	Consumer Services, Commercial, Home Mortgages, Trusts, International Services	Home Mortgages, Consumer Services, Commercial Real Estate Development
Capital Development	Net income	Sell stock shares in bank	Sell stock shares in savings and loan
Number (KS)	180	515	34
Total Assets (June '92) (KS)	\$1.86 billion	\$29.5 billion	\$11.6 billion
Average Size	\$10 million	\$57 million	\$341 million
Market Share	4.3%	68.7%	27.0%



KANSAS STATE DEPARTMENT
OF CREDIT UNIONS

WAYNE WARFEL

ADMINISTRATOR

400 KANSAS AVE., SUITE B
TOPEKA, KS 66603

OFFICE: (913) 296-3021
HOME: (913) 273-6269

2 of 3

WHAT ARE CREDIT UNIONS?

MEMBER-OWNED FINANCIAL COOPERATIVES

DEMOCRATICALLY CONTROLLED-ONE MEMBER, ONE VOTE

CONTROLLED BY BOARDS OF DIRECTORS
WHO SERVE VOLUNTARILY WITHOUT PAY

MEMBERS POOL THEIR SAVINGS TO LOAN TO OTHER MEMBERS

MEMBERS ARE UNITED BY A COMMON BOND - A GROUP OF EMPLOYEES,
AN ASSOCIATION, OR A GEOGRAPHIC AREA, FOR EXAMPLE

REGULATED BY EITHER A STATE OR FEDERAL REGULATORY AUTHORITY

KANSAS CREDIT UNIONS

TOTAL 179, 139 STATE CHARTERED, 40 FEDERALLY CHARTERED

COMBINED ASSETS TOTAL \$1.86 BILLION, SERVE 540,000 MEMBERS

ALL BUT THREE INSURED (DEPOSIT INSURANCE) BY THE NATIONAL
CREDIT UNION ADMINISTRATION (NCUA), AN AGENCY OF THE FEDERAL
GOVERNMENT. THE REMAINING THREE ARE INSURED BY MUTUAL GUARANTY
CORPORATION, A PRIVATE INSURER

ALSO THERE ARE THREE CORPORATE CREDIT UNIONS, INCLUDING
US CENTRAL CREDIT UNION, THE LARGEST CREDIT UNION IN EXISTENCE

OVERALL, KANSAS CREDIT UNIONS ENJOY VERY POSITIVE TRENDS
AND ARE WELL CAPITALIZED, 8.4% AT JUNE 30, 1992

ARE REPRESENTED BY THEIR STATE TRADE ASSOCIATION, THE
KANSAS CREDIT UNION ASSOCIATION (WICHITA)

KANSAS STATE DEPARTMENT OF CREDIT UNIONS

CREATED IN 1968 TO CHARTER, EXAMINE, AND REGULATE KANSAS
STATE CHARTERED CREDIT UNIONS

STAFF OF 12 EMPLOYEES, 5 ADMINISTRATIVE AND 7 FIELD EXAMINERS

AIDED BY THE CREDIT UNION COUNCIL, WHOSE 7 MEMBERS ARE
APPOINTED BY THE GOVERNOR AND PROVIDE ASSISTANCE IN AN
ADVISORY CAPACITY

EXAMINATION IS PERFORMED USING AN AUTOMATED SYSTEM,
THE AUTOMATED CORE EXAMINATION SYSTEM (ACES) PROVIDED
AND SUPPORTED BY NCUA AND BASED ON "CAMEL" RATINGS

FEE SUPPORTED AGENCY, CONTRIBUTING 20% OF OUR FEE INCOME
TO THE STATE GENERAL FUND

DEPARTMENT RELATED ACTIVITIES

RECODIFICATION OF OUR CREDIT UNION ACT

IMPLEMENTATION OF LEGISLATION REQUIRING FEDERAL INSURANCE

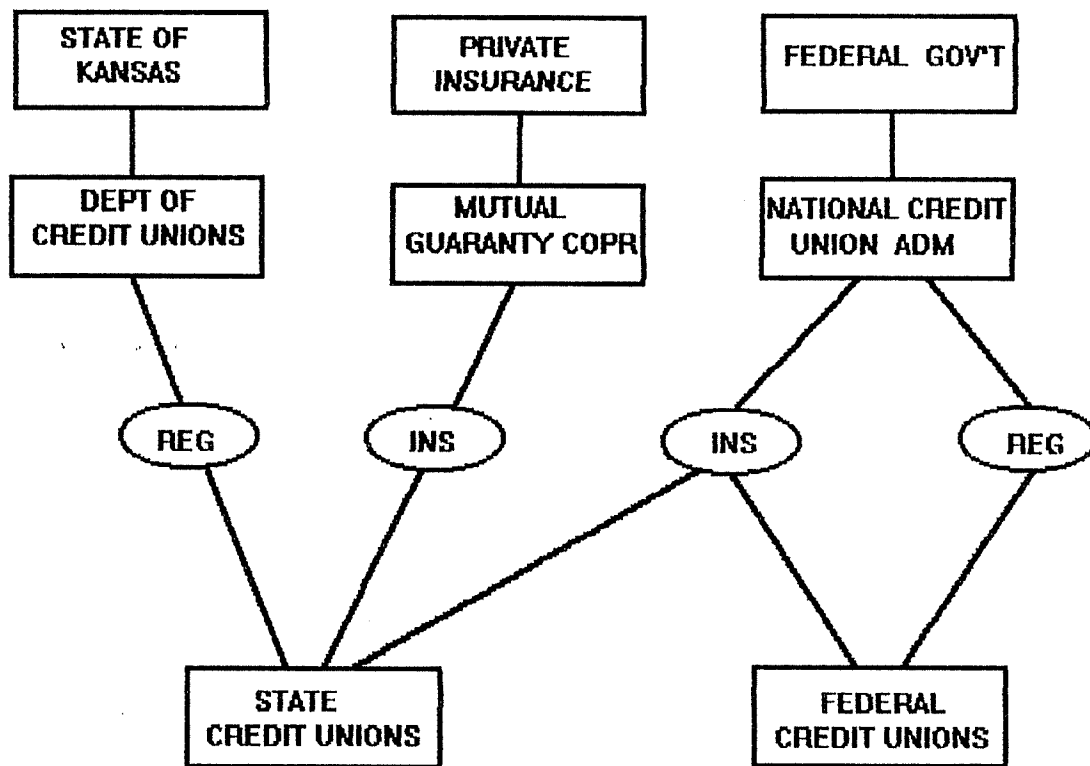
LEGISLATION REQUESTED THIS SESSION

KSA 17-2219 EXPULSION OF MEMBERS

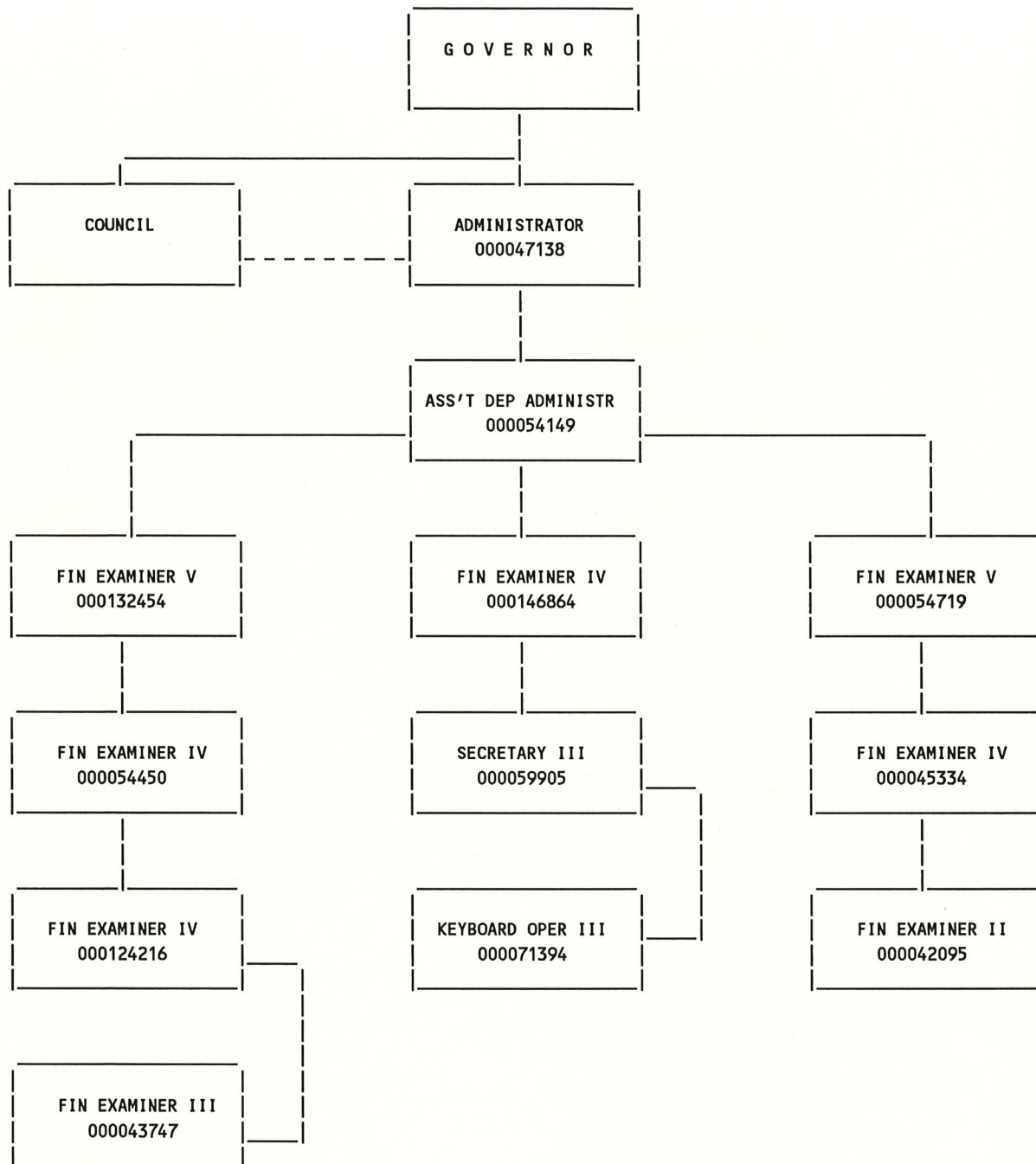
KSA 17-2227 CONFIDENTIALITY STATUTE

KSA 17-2232 CREDIT UNION COUNCIL APPOINTMENTS

CREDIT UNION REGULATORY AND INSURANCE STRUCTURE



KANSAS STATE DEPARTMENT OF CREDIT UNIONS
ORGANIZATIONAL CHART



REV 01/19/93

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KANSAS STATE DEPARTMENT OF CREDIT UNIONS

CAMEL RATING SUMMARY

AS OF 1/14/93

	#	%	\$	%
CODE 1	9	6.5	144.1	8.7
CODE 2	65	47.1	1,015.9	61.2
CODE 3	55	39.9	430.3	25.9
CODE 4	5	3.6	6.8	0.4
CODE 5	4	2.9	63.2	3.8
TOTALS	138	100.0	1,660.3	100.0

The Agency

DEPARTMENT OF CREDIT UNIONS

AGENCY OPERATIONS

The purpose of the State Department of Credit Unions is to examine all state-chartered credit unions at least every 18 months to assure compliance with all state and federal laws and regulations. The Department also is empowered to grant new charters, mergers, and provide liquidation procedures when necessary. The Department was created in 1968. The regulation of credit unions had previously been carried out by the State Bank Commissioner's Office. The Department is responsible for regulating state-chartered credit unions with assets ranging from \$25,000 to ~~\$50 million~~. The agency examines state-chartered credit unions to determine their financial stability and their compliance with laws and regulations and handles consumer complaints.

The state is not the sole regulator of Kansas credit unions. The National Credit Union Administration (NCUA), a federal agency, administers a federal system of credit unions operating in the state. This agency also grants charters, conducts examinations, and insures depositors' accounts. The state and federal systems overlap to a degree. State-chartered credit unions may insure their depositors' accounts through NCUA. To assess these credit unions' financial condition, the federal agency accepts examination reports from the Credit Union Department. State-chartered credit unions may also insure their depositors' accounts with the State Credit Union Share Insurance Corporation of Tennessee. Thus, although the function of insuring state-chartered credit unions is divided, the responsibility for examination, complaint administration, and the enforcement of regulations rests solely with the State Department of Credit Unions.

At present, there are 140 state-chartered credit unions. This is a decrease from 1980 when 191 existed. New credit unions have formed, but a greater number have closed. The decrease in credit unions generally represents mergers resulting from voluntary liquidations—the closing of a sponsoring company, for example—and mergers under regulatory advisement.

The credit union administrator is appointed by the Governor, subject to Senate confirmation, and serves a four-year term. When the Department was created in 1968, a separate Credit Union Council was also established. It is composed of seven members appointed by the Governor. The council has the statutory authority to review the activities of the Credit Union Department.

The Department of Credit Unions is a fee-funded agency; fees are received from each state-chartered credit union. Fees are assessed to individual credit unions based on the amount of assets each owns.

AGENCY OBJECTIVES

To examine all state-chartered credit unions at least once every 18 months.

To assure that state-chartered credit unions comply with state and federal laws and the Department's rules and regulations.

To resolve all consumer complaints received.

To identify and monitor financially unstable credit unions.

STATUTORY HISTORY

The Kansas State Department of Credit Unions was established in 1968 under KSA 17-2234. Information related to this agency and credit unions in general may be found in KSA 17-2201 through KSA 17-2267. KSA 17-2244 is a particularly important statute as it authorizes state-chartered credit unions to engage in the same activities as federally-chartered credit unions. KSA 17-2246 was amended by the 1991 Legislature to require all Kansas credit unions, other than central credit unions, to apply for insurance through the National Credit Union Share Insurance Fund (NCUSIF).

The Budget

DEPARTMENT OF CREDIT UNIONS

	FY 1992 ACTUAL	FY 1993 ESTIMATE	C LEVEL BUDGET	GOVERNOR'S RECOMMENDATION
Expenditures By Object				
Salaries And Wages	478,907	498,117	559,721	534,759
Contractual Services	91,239	108,855	126,202	106,716
Commodities	3,468	5,000	5,000	5,000
Capital Outlay	4,161	-	5,200	-
Debt Service	-	-	-	-
Non-expense Items	-	-	-	-
Subtotal: State Operations	577,775	611,972	696,123	646,475
Aid To Local Units	-	-	-	-
Other Assistance	-	-	-	-
Capital Improvements	-	-	-	-
Total Expenditures	\$577,775	\$611,972	\$696,123	\$646,475
Expenditures By Fund				
State General Fund				
State Operations	-	-	-	-
Aid To Local Units	-	-	-	-
Other Assistance	-	-	-	-
Capital Improvements	-	-	-	-
Subtotal: State General Fund	-	-	-	-
Other Funds				
State Operations	577,775	611,972	696,123	646,475
Aid To Local Units	-	-	-	-
Other Assistance	-	-	-	-
Capital Improvements	-	-	-	-
Subtotal: Other Funds	577,775	611,972	696,123	646,475
Total Expenditures	\$577,775	\$611,972	\$696,123	\$646,475
Full Time Positions	12.0	12.0	12.0	12.0

PERFORMANCE INDICATORS

	FY 1992 ACTUAL	FY 1993 ESTIMATE	FY 1994 ESTIMATE*
Number of state-chartered credit unions.....	144	140	138
Number of credit unions examined	135	135	138
Number of liquidations	2	1	0
Number of mergers.....	1	4	2
Number of letters of understanding issued.....	7	7	10

* Estimated level of performance under governor's recommendation.

9 of 3

INTRODUCTION TESTIMONY
House Financial Institutions & Insurance Committee
January 19, 1993

Chairman Bryant, members of the committee, I am Bill Henry, and I appear before you today on behalf of the St. Francis Regional Medical Center of Wichita, Kansas.

St. Francis Regional Medical Center requests the Committee to introduce a measure which would repeal a "technical" amendment that was added in Conference Committee in 1992 to S.B. 66. That measure dealt with the incorporation of Blue Cross-Blue Shield as a mutual insurance company. The technical amendment added in Conference Committee to S.B. 66 was a provision that allows Blue Cross-Blue Shield to utilize a procedure called non-assignment in paying health providers and Blue Cross-Blue Shield insured.

Non-assignment allows an insurance company, such as Blue Cross-Blue Shield, to make payments to individuals which it insures rather than the hospital which provides the care. Where non-assignment occurs there is greater difficulty in collecting for the services provided.

My client believes that non-assignment of insurance benefits is a public policy issue which should be considered by this Committee and thereby requests a bill be introduced which would revoke this non-assignment authority which only Blue Cross-Blue Shield holds. No other mutual insurance company has such authority in the state of Kansas.

I would be pleased to answer any questions which any members of the Committee might have on this issue.

Respectfully submitted,

Bill Henry

William M. Henry
Attorney at Law

*Financial Institutions
& Insurance*

Attachment 4

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