"Carved in Sand"

A Report on the Collapse of the Rhode Island Share and Deposit Indemnity Corporation

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EXECUTIVE SUMMARY

Why did the Rhode Island Share and Deposit Indemnity Corporation (RISDIC) fail? As elaborated in subsequent sections of this report, the answer is multi faceted. Different people in positions of leadership share the responsibility for RISDIC's collapse. In some respects, the system itself was bound to fail; in other respects, the operation of the system was faulty.

1. Many RISDIC members strayed from the original credit union concept. RISDIC was the only insurance fund in the country to mix credit unions with loan and investment companies. Some Rhode Island credit unions operated as banks, opening their doors to the general public, accepting large deposits, and venturing into commercial loans and other high-risk operations without adequate management controls. Some were poorly managed; some experienced abnormal and dramatic growth.

2. Some of RISDIC's members did not have adequate sources of liquidity--loans of cash to cover unexpected withdrawals. The R.I. Credit Union League's Corporate Credit Union (RICUL-CCU), the local liquidity provider for credit unions, promised lines of credit knowing that it could not deliver on them fully. The loan and investment companies did not have access to lines of credit from RICUL-CCU. This caused RISDIC to become a provider of liquidity thus deviating from its stated purpose of providing deposit insurance. By infusing $17,450,000 into Heritage Loan and Investment Company in October and November 1990 before knowing the size of Heritage's actual losses, RISDIC depleted its reserves available for its role as an insurer of other member institutions.

3. <u>RISDIC was unprepared to function as an insurer.</u> RISDIC staff and board members had no insurance training or experience. They had no capacity to evaluate the adequacy of RISDIC reserves in relation to potential losses and consistently opted for rebates to members instead of building reserves. A 1988 actuarial analysis commissioned by RISDIC used dubious and erroneous assumptions that significantly underestimated the chance of loss.

4. <u>RISDIC had no recourse to "deep pockets" outside of its own membership.</u> It lacked private reinsurance, and was not backed by the federal or state government. It relied on its own members for covering any losses larger than RISDIC's modest reserve fund. Any major crisis not only weakened RISDIC, but weakened its members, making it unable to withstand the next crisis.

5. <u>RISDIC's Board of Directors did not adequately oversee RISDIC's operations.</u> The Board lacked an audit committee, relied exclusively on RISDIC's president for information about RISDIC and its members, and overestimated the effectiveness of existing safeguards. RISDIC officers filtered out pertinent details with the result that board members did not see examinatin reports of RISDIC members and were not well-informed. Most of the directors represented RISDIC members, and were unwilling to scrutinize each other's institutions even though RISDIC was supposed to be regulating its members. Many board members neither understood nor exercised their full responsibilities for RISDIC's activities and purposes.

supported proposed legislation requiring federal deposit insurance for RISDIC institutions. While supporting the proposed legislation, she failed to deliver the report to the very legislators whom she had to convince of the need for the federal insurance, and the two Attorneys General differ as to whether she called the report to the attention of her successor. After he became Attorney General, even though he served as a member of the five member Board of Bank Incorporation, James O'Neil paid little attention to RISDIC or its insured members until the Heritage crisis came to his attention on November 1, 1990.

- General Treasurers Roger Begin and Anthony Solomon--members of the Board of Bank Incorporation (BBI) and responsible for the state's finances--invested state funds in RISDIC-insured institutions. Even though both General Treasurers had some reservations about the soundness of these institutions, they did not obtain access to DBR examinations, utilize the BBI to seek information, or conduct their own investigations before depositing state funds.

INTRODUCTION TO THE STUDY

On December 31, 1990, the Board of Directors of the Rhode Island Share and Deposit Indemnity Corporation (RISDIC) adopted a resolution requesting "the immediate appointment of a conservator by the Department of Business Regulation."[1] On January 1, 1991, newly inaugurated Governor Bruce Sundlun announced Executive Order No. 91-2 that appointed the director of the Department of Business Regulation as conservator and directed the closing of all credit unions and loan and investment companies insured by RISDIC.[2]

On January 7, 1991, Governor Sundlun requested Vartan Gregorian, President of Brown University, to conduct a study of the reasons for the failure of RISDIC.[3] Soon thereafter, Mr. Gregorian met with Governor Sundlun and subsequently with Attorney General James E. O'Neil, and accepted the assignment on the condition that he have complete autonomy to work independently of the Governor's and Attorney General's offices. He did not seek subpoena powers and expressed his intent to conduct the study with care not to interfere with ongoing civil and criminal investigations related to RISDIC's collapse.

From a desire to maintain independence, no resources from the State of Rhode Island were used to support the study. Due to this and time

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[1] The full text of the board's resolution and its chairman's subsequent letter to the director of the Department of Business Regulation and the Governor are reproduced as Appendices 1 and 2.

[2] Executive Order No. 91-2 is reproduced as Appendix 3.

[3] The Governor's letter to Mr. Gregorian is reproduced as Appendix 4.

constraints imposed by the urgency of its subject, Mr. Gregorian requested a small number of colleagues to assist him, limited the scope of the study to an analysis of RISDIC's collapse as a deposit insurance system, and relied on information available through interviews and documents volunteered by state officials and private citizens.

On January 17, by Executive Order No. 91-6, Governor Sundlun declared Mr. Gregorian and his designees agents of the State of Rhode Island for all actions taken in furtherance of the Governor's commission.[4]

Mr. Gregorian requested Benjamin R. Sturges, a retired bank director, to assist him with the study; Harvey M. Spear, Esq., of New York City as special counsel to the Commission; Thomas M. Dickinson, Esq., of Providence, R.I. as local counsel; David G. Lubrano, Brown University trustee emeritus; Victoria S. Escalera, C.P.A. and C.I.A., Brown University Auditor, and Professors Ross Cheit and Peter M. Garber, also of Brown University, as consultants, all to serve pro bono publico. In addition, the shorthand reporting firm of Reporting Associates of Providence, R.I. agreed to record all interviews by Mr. Gregorian, pro bono publico.

During the investigation, Mr. Gregorian and his advisors interviewed 54 people, including past and present members of the RISDIC board of directors and staff, independent certified public accountants, officials of the State of Rhode Island, employees of Rhode Island's Department of Business Regulation, members of the Rhode Island General Assembly, officers of leading local commercial banks, and officers of national credit union organizations and regulatory agencies.[5] The interviewers

[4] Executive Order No. 91-6 is reproduced as Appendix 5.

[5] A complete list of those interviewed and a synopsis of each one's opinion as to why RISDIC failed appears as Appendix 6.

appreciate the cooperation of these individuals, and regret that the study was not enlightened by the opinions and knowledge of former Attorney General Arlene Violet; RISDIC directors Norman Baris, John R. Lanfredi, William J. McEnery, and Charles Paquin; or RISDIC's attorney James Santaniello, each of whom declined to be interviewed by Mr. Gregorian.

The study group was able to view the videotape of a critical 1986 legislative committee hearing, thanks to State Representatives Robert Bianchini and Joseph DeAngelis, each of whom loaned a personal copy of the tape to Mr. Gregorian. In addition, the group examined thousands of pages of documents relevant to RISDIC and its member institutions including financial statements, examination reports, and meeting minutes, as well as numerous documents and reports relating to the credit union industry and the manner in which it is insured in other states. All the documents pertinent to this study have been turned over to the Governor's office with this report.

The study was limited to analyzing why the RISDIC system for insuring 300,000 depositors' funds did not work. Mr. Gregorian and his advisors did not have access to state police and grand jury records, and did not delve into areas pertaining to possible civil and criminal violations. Mr. Gregorian has already advised the Governor in a letter of February 13, 1991, that "it is not only appropriate but necessary for the State to pursue further investigation with an unbiased and competent out-of-state investigator with subpoena power and other investigative tools."[6] Those

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[6] The full text of Mr. Gregorian's preliminary reports are reproduced as Appendices 7 and 8.

who worked on this report hope that their efforts provide a sound basis for such subsequent investigation.

SECTION I: THE RISDIC NETWORK

A. OVERVIEW OF RISDIC

RISDIC was chartered by the General Assembly in 1969 and started operating in 1971 as a non-profit entity "for the purpose of creating and maintaining a fund for the insurance of share savings and deposits of members or depositors."[7] Membership was limited to credit unions at first. Deposit insurance was not mandated by law, and RISDIC began with 40 members and insured deposits of $133.9 million.

In 1976, the General Assembly amended RISDIC's charter to allow banks and other financial institutions to become members. The following year, a bill was enacted mandating insurance for all deposit-taking institutions by 1982. As the chart reproduced in Appendix 9 indicates, membership grew to a high of 78 members in 1980 with insured deposits of $760.7 million. By 1990, RISDIC's membership had declined to 46 members, but insured deposits had grown to over $1.5 billion.

Each member maintained on deposit with the Corporation one percent of eligible shares and deposits, adjusted semi-annually. These deposits served as the central fund to fulfill the insurance guarantee of the Corporation. In addition, members were assessed an annual fee equal to 1/12 of 1% of eligible deposits. These fees were income to the Corporation. Beginning in 1977, the RISDIC directors declared and paid to their

[7] RISDIC Charter, Section I.

members rebates of 50% of the assessments.[8] This practice was repeated several times.

In addition to its primary responsibility as an insuring entity, RISDIC conducted examinations of members and provided supervisory and technical assistance.[9] RISDIC was proud of what it perceived to be its financial strength and acumen, as well as its success in monitoring and assisting its members. In 1985, RISDIC claimed to be "the best in the nation" and the "nation's model"[10] and boasted that "the soundness and safety of RISDIC has been tested and our fiscal integrity has prevailed. No deposit insurance entity including FDIC, FSLIC, or NCUA can match RISDIC's impeccable record in the rehabilitation of financial institutions."[11] That same year, the president of RISDIC, Peter A. Nevola, announced that "the success of our protection systems together with the strength of the fund and our member institutions, resulted in the Board of Directors' ability to approve a 5.1 percent dividend on the primary capital contributions to the fund."[12] In 1986 the Board approved a 2.5 percent dividend,[13] and another dividend was approved in 1987.

Joseph Bellucci, chairman of RISDIC's board of directors, echoed this confidence and pride, commenting in RISDIC's 1985 Annual Report that:

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8 RISDIC 1977 Annual Report, p. 7.

9 Anthony Piccirilli, op. cit., p. 14.

10 RISDIC 1985 and 1986 Annual Reports, p.2

11 RISDIC 1985 Annual Report, p.2

12 Ibid, p.3

13 RISDIC 1986 Annual Report, p.3.

> RISDIC members are indeed fortunate that they are part of a deposit insurance entity that has an impeccable record in the rehabilitation of financial institutions. The soundness and safety of RISDIC has been tested over and over again. No financial institution insured by RISDIC need fear that its right to conduct its business in a safe, lawful manner be threatened by federal insurance regulations issued to attempt to solve problems that arise in states that are in no way similar to the Rhode Island economic environment.[14]

RISDIC repeated claims about its strength and security in advertisements in subsequent years, stating that its commitment to the depositor was "carved in stone."[15] As subsequent sections of this report describe, however, RISDIC's leaders were overly confident that the monitoring, examination, and management assistance functions they performed could prevent problems from becoming insurable losses. In this regard they were deluding themselves, the legislature, the citizens of the State and countless depositors.

B. RISDIC AS AN INSURER

1. The Concept of Private Insurance

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[14] RISDIC 1986 Annual Report., p.2

[15] Televised advertisements for RISDIC in 1990 used these words with the image of the RISDIC seal being chiseled in granite.

There is considerable confusion about the nature of private versus federal deposit insurance. FDIC charges the federal bank insurers annual premiums in a manner similar to most forms of private insurance (except private deposit insurance). The federal mechanism for insuring credit unions, however, administered by the National Credit Union Administration (NCUA) and called the National Credit Union Share Insurance Fund (NCUSIF), does not operate in the same manner as FDIC.

Neither NCUSIF, RISDIC, nor the small number of other private deposit insurers in the country, charge annual premiums in the traditional sense. The NCUSIF system has become increasingly dominant for credit unions. Eighty-one percent of all credit union shares were NCUSIF-insured in 1982. Ninety-six percent were NCUSIF-insured in 1989. The remainder were insured by one of nine private deposit insurers who were operating without apparent difficulty when RISDIC collapsed.[16] Only twelve states actually required participation in NCUSIF in 1989, while thirty-three, including Rhode Island, allowed credit unions to choose between federal and private insurance.

Private deposit insurance does not operate like better-known forms of private insurance; rather, it is a kind of mutual insurance known as cooperative insurance. The basic form of cooperative deposit insurance is as follows: members keep one percent of their deposits in a joint reserve fund, there are annual assessments according to need, and in many years dividends are issued at the end of the year. This form was pioneered by

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[16] Two were multi-state operations: NDIC (an Ohio-based insurer that covers credit unions in 22 states) and Mutual Guaranty (a Tennessee-based insurer that covers credit unions in five states). The seven state-chartered funds were in Florida, Texas, Massachusetts, Georgia, Maryland, Washington, and California. The funds in Florida, Georgia and Texas will probably be phased out in light RISDIC's collapse.

private insurers and adopted by NCUSIF in 1984; its success elsewhere suggests that RISDIC's basic structure was not necessarily doomed to fail.

Supporters of federal insurance claim a significant advantage in the fact that NCUSIF is backed by "the full faith and credit" of the federal government. The importance of this guarantee is debatable. As is apparent from the current savings and loan crisis, federal assistance is available only through congressional appropriations. Moreover, since NCUSIF is a cooperative insurer, it would have to exhaust the funds of its own members before going to Congress to get the federal government's funds.

RISDIC was often compared favorably to NCUSIF, based largely on the fact that RISDIC had a higher ratio than NCUSIF of reserves to deposits. But this comparison ignores three critical underlying differences that rendered RISDIC much less stable than NCUSIF: RISDIC had less risk spreading, poorer risk mixture, and an unmet need for risk transference.

2. Risk Spreading

The concept of insurance works well only if risks are spread far and wide enough. Two problems can occur if the membership base of an insurer is too thin: conflagration and risk concentration. Both were problems at RISDIC.

Generally, risks should be spread geographically in order to avoid interdependent losses, or the problem of conflagration. This problem is sometimes illustrated as the problem of writing fire insurance for every house on one block, where a fire at one house might spread to many others. In the context of deposit insurance, the concern is regional

economic downturns. A national membership base is better positioned to weather such problems than one limited by state boundaries, particularly those as confining as Rhode Island's. NCUSIF has the advantage of doing business in all fifty states. The largest private deposit insurer in the country, National Deposit Insurance Corporation (based in Ohio), also has a substantial base: over 400 members in twenty-two states. By contrast, RISDIC's risks were highly concentrated: by 1990, less than 50 members in one small state. RISDIC was not necessarily doomed because it only did business in Rhode Island, but this limitation certainly increased the need for a method of transferring some of the risk through mechanisms such as reinsurance.

RISDIC recognized the benefits of broadening its base, particularly after its membership began declining in 1980. RISDIC officials conferred with interested parties in several states. In 1983, RISDIC began insuring its first out-of-state institution, an industrial bank in Minnesota.[17] DBR Director Calderone, who had already expressed to RISDIC serious concerns about various member institutions, challenged RISDIC's authority in court.[18] RISDIC won in the Rhode Island Supreme Court, but ultimately lost with DBR.[19]

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[17] Commercial Credit Plan (MN) was approved for insurance by RISDIC Board of Directors on September 13, 1983.

[18] Director Calderone attended a RISDIC Board meeting to express serious concerns about six "problem institutions" and "unverified information that some institutions are involved in fraudulent loan applications." Minutes, RISDIC Board of Directors, November 11, 1982.

[19] The court held that RISDIC's state-charter did not prohibit insuring deposits outside of Rhode Island. Moore v. Rhode Island Share and Indemnity Corp., 495 A.2d 1003 (RI 1985). But the court pointed out that the Director of DBR was empowered to suspend any RISDIC operation deemed "unsafe, unauthorized, or dishonest." DBR apparently prevailed on RISDIC to cease the practice.

The other problem in spreading risk involves the concentration of large risks. The power of insurance comes through the "law of large numbers." The larger the number of policyholders, the stronger the insurance system. Major catastrophes, if spread across enough other members, are transformed into moderate, predictable premiums. In cooperative insurance arrangements, where there are no actual premiums, the size of the membership is most relevant if there is a reassessment to cover losses. One measure of fund stability, then, is its relationship to the largest possible losses. Similarly, it is important to consider how likely it is that losses in any given year will be covered by the fund.

The answer does not turn on the percentage of reserves to total deposits. Private and federal cooperative funds were generally required by statute to have at least one percent of deposits in reserve. RISDIC's ratio of funds to deposits, as its supporters often pointed out, was generally better than NCUSIF's.[20] But this ratio hides a fundamental weakness in RISDIC: the inability of the fund to absorb the loss of its largest members. In this way, the difference between RISDIC and NCUSIF was critically significant. The federal fund, spread across thousands of members, can easily absorb the loss of a large member.[21] RISDIC, by contrast, became increasingly top-heavy over the years. RISDIC's three

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[20] Its reserves were usually between 1.5% and 1.9% of deposits. See, for example, DBR's Examination Report on RISDIC, August 31, 1989, reporting 1.88 percent. The NCUSIF reserves were closer to one percent..

[21] NCUSIF reserves are large enough, according to one source, to absorb the cost of liquidating the six largest credit unions that might imperil the fund. "That wouldn't wipe out the fund; it would simply lower the current insurance coverage ratio from about $1.26 down to $1.11." Bill Hampel, CUNA economist, cited in "Could a few bad apples spoil NCUSIF?" Credit Union Magazine, October 1990, p.39.

largest members accounted for 30 percent of RISDIC-insured deposits in 1977, 45 percent in 1988. (See Appendix 10.)

The assets of RISDIC's three largest members were more than twenty-five times greater than RISDIC's $25-million fund in 1990. Indeed, ten of RISDIC's forty-six members had assets larger than this fund.[22] It is doubtful whether RISDIC could have sustained the loss of even one of its ten largest members. Only three of these institutions have reopened.[23] RISDIC's strong incentive to keep these institutions alive helps to explain its indulgent regulatory stance toward some of them.

RISDIC violated some of the industry guidelines it publicly endorsed. In order to allay concerns about the soundness of private deposit insurance, the national organization of cooperative credit insurers developed "minimum operating procedures for prudent management of cooperative credit union insurers." The RISDIC Board of Directors adopted these standards on November 12, 1985. RISDIC did not adhere to either of the provisions in these standards for managing risk concentration, nor did it comply with the independent audit requirement.[24]

To manage risk concentration, the IS&DGA Standards required each Fund to "maintain a profile and analysis of risk concentration as measured

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[22] In ascending order, the institutions and their total deposits (in millions) were: Westerly (52.3), Columbian (74.1), RI State Employees (85.4), Union Deposit (86.4), East Providence (102.4), Pawtucket (102.7), Davisville (118.3), Greater Providence (163.1), RI Central (192), and Marquette (281.3).

[23] Six did not qualify for federal insurance, including five of the six largest. Pawtucket Credit Union has reopened, along with Rhode Island State Employees and Westerly. Union Deposit sold its loan portfolio and paid off all depositors.

[24] The IS&DGA standards required annual audits by a committee including a non-competing IS&DGA member, an independent CPA firm, state regulatory authority, and IS&DGA management. RISDIC did not comply with this requirement.

by insured shares per institution as a multiple of insurer's capital." RISDIC did not fulfill this requirement. The standards also require that insurers "provide through reinsurance commitments to other contingency plans a means for responding to significant problems in the Fund's largest insurers." RISDIC did not comply with this provision either. It had neither reinsurance nor any alternative plan for handling substantial losses.

3. The Mixture of Risks

Most insurance systems are built on the concept of risk classification. Similar risks are aggregated together but significantly different risks are charged different rates or covered under separate policies. This is reflected in the two separate federal deposit-insurance systems (FDIC and NCUSIF). The NCUSIF, being restricted to "true blue" credit unions, is undoubtedly the more stable of the two. RISDIC's mixture of risks was much more volatile than NCUSIF's. As noted earlier, RISDIC allowed two practices avoided almost entirely by NCUSIF: commercial loans and large accounts.

a. Loan and Investment Companies. Perhaps the most volatile change in RISDIC's mission was the inclusion of loan and investment companies as insured members in 1976. This single feature distinguishes RISDIC from all other examples of cooperative credit union insurance, both private and governmental.

Loan and investment companies engage in much riskier lending practices than traditional credit unions. For all practical purposes, they are

banks.[25] Some of the state-chartered credit unions in Rhode Island also operated much like banks. These institutions made commercial loans, adding a "very serious risk" that the largest private deposit insurer, the Ohio-based National Deposit Insurance Corporation, will not underwrite.[26]

Loan and investment companies seem to account for a disproportionate share of RISDIC'S problems. The three largest loan and investment companies in 1988 were Greater Providence Deposit Corporation, Heritage Loan and Investment Company, and Jefferson Loan and Investment Company. The collapse of the latter two toppled RISDIC, and Greater Providence was long the source of concerns ranging from political influence to harassment of bank examiners. Moreover, RISDIC's handling of the Heritage situation in November 1990 may be explained by the run in 1985 on another loan and investment company: Commercial Credit Bank.[27]

How did RISDIC get into the business of insuring entities that other private deposit insurers generally spurn? Quite bluntly, they stepped in to

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[25] Shortly after obtaining demand-deposit powers from the General Assembly in 1971, Greater Providence Deposit Corp. obtained a letter from the Securities and Exchange Commission indicating that Greater Providence qualified as a bank for the purpose of federal statutes. Donald Breed, "State's top loan-investment firm applies for deposit insurance," Providence Journal, November 18, 1976.

[26] Dennis Adams, tr. 25.

[27] Commercial Credit Bank is another case of a loan and investment company that grew enormously over time, from deposits of $6 million in 1977 to over $210 million in 1983, when it was RISDIC's largest member. Commercial Credit suffered a serious run in June 1985. This run has been attributed to general concerns about the problems with private insurance in Ohio and Maryland. See the 1987 Stitt Memorandum, p. 15. In fact, the run was created by a story indicating that Commercial Credit was going to stop accepting new deposits. Jan Brogan, "Commercial Credit to bar new deposits," Providence Journal, June 22, 1985. See also, Jan Brogan and Doug Cumming, "Credit bank weathers run on $7.5 million," Providence Journal, June 25, 1985; Jan Brogan, "A run that didn't need to be: Commercial Credit cash rich--but confusion triggered panic," Providence Journal, July 2, 1985.

satisfy the demand from some FDIC-rejects. Rather than providing "choice" to credit unions, RISDIC originated as a kind of insurer of last resort--first for Heritage, and then for Greater Providence, although the story begins with Greater Providence.[28]

In February 1975, the Providence Journal linked political favoritism to several million dollars in non-interest-bearing accounts at Greater Providence.[29] The article also criticized Greater Providence for lacking deposit insurance, which was then optional under Rhode Island law. Later that week, Mayor Vincent A. Cianci, citing the lack of deposit insurance, withdrew $475,000 in city accounts from Greater Providence.[30] Greater Providence applied to the FDIC for insurance several months later.[31]

None of the nine loan and investment companies in Rhode Island had deposit insurance in early 1975. Later that year, according to a newspaper story, the Board of Bank Incorporation required deposit insurance of the newly-chartered Heritage Loan and Investment Company as a condition of its moving into its new office.[32] "Heritage tried FDIC first...then RISDIC obtained enabling legislation [March 31, 1976] allowing it to insure

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[28] Indeed, demand deposit power was given to loan and investment companies "by the General Assembly in 1971 at the behest of Greater Providence Deposit." Donald D. Breed, "L&I company seeks new deposit powers," Providence Journal, April 19, 1977.

[29] Jack White and Randall Richard, "Millions in State money go to 'favored' banks," Providence Journal, February 16, 1975.

[30] Merrill Bailey, "City is Withdrawing Funds from Bank," Providence Journal, February 21, 1975.

[31] Donald Breed, "Two Institutions Apply for FDIC," Providence Journal, March 5, 1975.

[32] Donald Breed, "State's top loan-investment firm applies for deposit insurance," Providence Journal, November 18, 1976.

deposits of financial institutions besides credit unions."[33] RISDIC promptly accepted Heritage as its first loan and investment company member.

The American Bank and Trust Co., another Rhode Island loan and investment company whose demise directly affected the handling of the RISDIC crisis, was the second candidate to apply for RISDIC coverage.[34] To its credit, RISDIC declined to insure a sinking ship. The bank was placed in receivership two months later: November 15, 1976.[35] It was the first Rhode Island bank failure since 1928. Later that week, Greater Providence, whose 18-month-old FDIC application was "still pending," applied to RISDIC for deposit insurance.[36] The application was readily accepted, and Greater Providence instantly became RISDIC's third largest member. Two other loan and investment companies joined RISDIC in 1976: Domestic Safe Deposit, and Commercial Credit. In its 1976 RISDIC Annual Report, RISDIC welcomed the first non-credit union institutions and extended its "hand in friendship to those few non-credit union institutions which may be directed toward participation with RISDIC, confident that RISDIC will be always and overwhelmingly, a creature of the Credit Union Industry of the State of Rhode Island."[37]

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[33] Id.

[34] For a lengthy account of this fiasco see, Donald Breed and Randall Richard, "How the American Bank & Trust went bust," Providence Journal, April 17, 1977.

[35] The state "bailed out" American Bank and Trust in March, 1977, by allowing tax credit to institutions that incurred losses in connection with the disposition of its assets. In order to make sure that this didn't happen again, the General Assembly enacted legislation mandating deposit insurance at all financial institutions by 1982. This is the same law Governor Sundlun cited when he closed RISDIC's member institutions on January 1, 1991.

[36] Donald Breed, "State's top loan-investment firm applies for deposit insurance," Providence Journal, November 18, 1976.

[37] RISDIC 1976 Annual Report, p.1

b. Large Accounts. Credit unions were founded to "benefit people of limited means, mostly wage earners."[38] Individual accounts were normally modest, never immense. Through its first ten years, RISDIC limited coverage to accounts under $40,000, matching the ceiling imposed by federal insurers. When the federal limit was raised to $100,000, RISDIC raised its limit as well. Six of the ten private deposit insurers doing business in the United States in 1990 had strict limits on account size. These limits were generally consistent with the federal limit of $100,000.

RISDIC removed the $100,000 limit in August 1985, adopting rules and regulations for "excess insurance" (up to $500,000) and "additional excess insurance" (for accounts, without any specified maximum, over $500,000).[39] These rules took effect by default--the DBR Director had 45 days to overrule them, but he declined to exercise that power. RISDIC's Executive Committee started taking applications for excess insurance before the 45 days had elapsed.[40] Soon thereafter, the RISDIC Board approved six credit unions and Heritage Loan and Investment Company for insurance on accounts up to $500,000. One was also approved for "additional excess" in connection with a single deposit of $4 million.[41]

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[38] National Credit Union Administration, Development of Federal Credit Unions (October, 1972), p. 2.

[39] RISDIC Board Minutes, August 6, 1985.

[40] RISDIC Executive Committee Meeting Mintues, September 4, 1985.

[41] The members approved for excess insurance were: Columbian, Providence Teachers, R.I. State Employees, R.I. Central, Pawtucket, and Marquette. At the same meeting, R.I. State Employees' Credit Union was also approved for additional excess coverage "for the Rhode Island College account." (Minutes, RISDIC Board, October 8, 1985, p. 4.) The amount of coverage is not indicated in the minutes, but an entry on October 13, 1987 reveals that the amount was later increased from $4 to $5 million.

Large accounts pose two possible risks to the stability of financial institutions. First, the likelihood of a run is increased when a small number of depositors account for a substantial portion of deposits. As Special Counsel Benoit noted in his 1986 memorandum, "payments to forty (40) depositors . . . in the amount of $500,000 each would more wipe out RISDIC."[42] Second, institutions in search of large depositors sometimes attract them by offering above-market interest rates which can only be sustained through high-risk ventures. This Commission does not have sufficient information to determine the role of large accounts in the run on Rhode Island Central Credit Union in late December, 1990. Nor did it obtain sufficient information to understand the role of large accounts in explaining how various RISDIC members were able to increase deposits dramatically over time. There is sufficient evidence to suggest, however, that RISDIC violated its own rules with respect to these accounts.

RISDIC's rules and regulations provide that applications for "excess insurance" shall be processed in accordance with the basic provisions for RISDIC membership.[43] There are no special written standards or criteria for these accounts, but RISDIC apparently applied the same CAMEL-rating requirements[44] to these accounts that it applied to accounts over $500,000. The RISDIC Board Minutes of October 8, 1985, note that "the Executive Committee recognized the overall monitor rating of each applicant [for excess insurance] being within the two highest levels." By this criterion,

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[42]Benoit Memorandum, February 20, 1986, p. 25.

[43] RISDIC Charter, Article II.

[44] The CAMEL rating system is explained further in Section D. The highest rating is "1" and the lowest rating is "5."

some of the institutions with excess insurance should have had it rescinded. For instance, it is highly unlikely that Marquette qualified since it was constantly in difficulty in the early 1980s. RISDIC literally took over the institution during this time. In the DBR examination report of April, 1986, Marquette had an overall rating of "3."

Documents available for this study do not indicate what proportion of deposits at RISDIC-insured institutions were held in accounts over $100,000. Published records from thirteen closed institutions suggest that it was considerable, amounting to $166.7 million.[45] These large accounts represented 12.7 percent of all frozen deposits but only .3 percent of all frozen accounts. Four of these institutions (Columbian Credit Union, Davisville Credit Union, Greater Providence Deposit Corporation, and PierBank) were below the CAMEL requirements set forth in RISDIC's rules.[46] As many as six of these institutions might not even have had the authority for such accounts, in that they did not offer insurance on them.[47]

Under RISDIC's rules and regulations, accounts over $500,000 had to be approved individually, coverage was automatically terminated after one year, and "such Member shall have achieved a rating of not less than two (2) in the Management and overall categories of the Corporation's five (5)

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[45] See table in the Providence Journal, January 25, 1991, based on information released by the Governor's Office.

[46] The large accounts in these institutions totalled over $49 million on January 1, 1991, representing thirty percent of the accounts over $100,000.

[47] The Providence Journal listed thirteen closed institutions with accounts over $100,000. This accounts for five of the original seven members approved for excess insurance. The sixth, R.I. State Employees, was reopened; the seventh, Heritage, was closed in November, 1990. Davisville was later approved for excess insurance after the original seven. This suggests that the large deposits at six or seven of the closed institutions should not be considered insured.

point rating system called the CAMEL rating system."[48] The RISDIC minutes do not reveal any instance in which the Board rejected an application for additional excess insurance. RISDIC's president stated that applications were rejected on occasion, but that rejections were not included in the minutes.[49] Other board members suggested that the approval of such applications was "rubber-stamped."[50]

Some of these approvals were in clear violation of RISDIC's own rules and regulations. Marquette Credit Union, for example, was approved for additional excess insurance on September 10, 1986, less than five months after it received an overall CAMEL-rating of "3" from the Department of Business Regulation. By the same examination Marquette's "sound surplus," required by state law to be at least five percent, was 1.7 percent. Marquette was approved for additional excess insurance on several accounts the following year, by which time their rating had improved to a "2."[51]

4. Risk Transference

Private insurance schemes often involve risks larger than the insurer can safely absorb. This explains the prevalence of reinsurance, a

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[48] RISDIC Rules & Regulations, Section 203.10(a) [excess insurance] and Section 216.1 [additional excess].

[49] He cited the example of Davisville Credit Union. Peter Nevola, tr. 14. Minutes of the RISDIC Board indicate that Davisville was approved for excess insurance on June 9, 1987. The minutes say nothing about additional excess.

[50] Eugene Leco tr., p. 4.

[51] See, for example, RISDIC Board Minutes of March 4, 1987 ($1.5 million) and September 15, 1987 ($2 million).

method for transferring risks that cannot adequately be borne by one insurer. Reinsurance pervades the property and casualty industry. NCUSIF does not have reinsurance, but through its large membership base, the federal fund has far greater capacity to absorb large losses. RISDIC, on the other hand, lacked reinsurance ever since Aetna stopped selling it in 1981. The loss of reinsurance caused considerable concern among RISDIC's outside auditors.

The RISDIC minutes indicate continuing concern over the issue of reinsurance throughout the 1980s.[52] It is not clear whether private reinsurance was completely unavailable during this time, or whether RISDIC considered the cost prohibitive. It is clear that RISDIC needed reinsurance for reasons well beyond general concerns about consumer confidence because, through its largest members, RISDIC was exposed to losses far larger than the fund could ever satisfy.

An actuarial consulting firm, Milliman & Robertson (M&R), analyzed RISDIC's condition in 1988. They concluded, according to Peter Nevola, that RISDIC was in "very, very strong" condition,[53] and it appears that RISDIC did little with the report. The insurance specialist who assisted Mr. Gregorian in this study reviewed M&R's report, and disagrees with the conclusion suggested by RISDIC's president. Even taking the report at face value, RISDIC was anything but secure. By one estimate in M & R's report, there was about a 1 in 200 chance that RISDIC would suffer an annual loss in excess of $25 million. However, that estimate was based on some highly

[52]For example, October 21, 1981: "Mr. Bianchini reported that a reinsurance program is being developed and is close to being ready for presentation"; September 6, 1988: "proposals for actuarial analysis and reinsurance evaluation."

[53] Nevola tr., p. 48.

questionable assumptions about the severity and frequency of possible losses. Correcting the worst assumptions, the odds of a $25-million loss are more like 1 in 50.[54]

C. RISDIC STAFF AND THEIR FUNCTIONS

Throughout the 1980's RISDIC employed approximately twelve people, and it retained outside legal counsel from James Santaniello, annual audit services from Arthur & Young (which became Ernst & Young in 1989), and occasional consultants as needed. In 1981, following a bitter power struggle, RISDIC's Board hired Peter Nevola, then state banking commissioner, to become president. He recruited two examiners from DBR to beef up the monitoring and examination functions at RISDIC. Kenneth Proto became vice president for examinations and Daniel Richer became vice president for monitoring and internal controls in 1982. The majority of RISDIC's professional staff members were hired right out of college, received on-the-job training at RISDIC, and were with RISDIC throughout the 1980's. The examination staff numbered five, only one of whom had credentials as a CPA. There was also a full-time monitoring analyst, a part-time bookkeeper, two secretaries for the executive staff, and a receptionist. All were well compensated by local accounting-industry standards, on a par or better than comparable DBR staff.[55]

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[54] See Appendix 11 for a full analysis of the actuarial report.

[55] In 1990, RISDIC salaries ranged from an approximate $30,000 annualized rate for experienced clerical and bookkeeping staff to a range around $40,000 for examiners, in the high $50,000's for each of the vice presidents, and over $100,000 for the president. The benefits package was also generous, particularly for the president who had the use of a BMW automobile, substantial amounts of life insurance with premiums paid by RISDIC, and a generous budget for business meals, travel, advertising, and entertainment.

There appears to have been camaraderie among the RISDIC staff, along with strict adherence to the chain of command. Staff members did not seem to be curious, or expect to be informed, about what transpired at higher levels of the organization after they passed information along.[56]

In 1989, the National Association of Share Insurance Corporations, successor to IS&DGA, drafted a plan aimed at providing cooperative reinsurance to private deposit insurers. RISDIC was one of the original signatories of this plan, which was supposed to have been implemented in June, 1990. RISDIC adopted the standards in 1989.[57] Section 7.8 of these standards sets forth the following requirement: "Each participant shall monitor every member institution whose assets exceed its own with special scrutiny." The record indicates that RISDIC did not apply special scrutiny to its largest members.[58] RISDIC placed magazine advertisements, however, touting the strength of its "strict monitoring controls."

1. Monitoring Members

An advertisement for RISDIC that appeared in the Callahan's Credit Union Directory claimed:

> Our financial monitoring controls are strict, precise and rigorous. We boast one of the most sophisticated advance monitoring systems in the country. And the majority of our people are former state or federal bank examiners with a lot of

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[56] See e.g., Goulet tr., p.29 and Proto tr. p. 23.

[57] RISDIC Board Minutes, December 19, 1989.

[58] Richer tr., p. 16; Goulet tr., pp. 24-5.

> experience in handling the extensive monthly reports required of our member institutions.[59]

This overstated the facts considerably.

The sophisticated team of experienced financial analysts that one envisions from the advertisement consisted of the monitoring analyst--an employee who had worked at RISDIC since her graduation from college in 1981, who also, to her credit, had recently completed an MBA degree at a local college. Her only previous experience as an examiner was on RISDIC's staff during her first few years of employment. She reported directly to the vice president for monitoring and internal control (who also functioned as RISDIC's controller). The latter had worked at DBR as a bank examiner for six years following his graduation from college, and had been at RISDIC since 1982. The monitoring analyst shared with him, in conversations and memos, any information from her quarterly analysis that she thought required follow-up. The vice president would decide whether to follow up, and he would perform the follow-up himself.[60] Monthly statements were not required by RISDIC, but were volunteered by member institutions in whatever format they used in reporting to their own board of directors.[61] Since the format and details of these statements differed by institution, these were not the primary focus of the monitoring analyst's efforts. In the case of Heritage, monthly financial statements were never received, but this did not raise special concerns because the staff considered this "requirement" discretionary.

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[59] The full advertisement is reproduced as Appendix 12.

[60] Goulet tr., pp. 28-29.

[61] Richer tr., p.11; and Goulet tr., p. 20.

The monitoring of quarterly financial statements was more extensive, possibly because quarterly reports were also required by DBR. The monitoring analyst would review the information for any obvious errors, correct them, and type the data into a computer spreadsheet to calculate specific ratios. Summary results were communicated in a report to both of RISDIC's vice presidents. But again, RISDIC's actions did not live up to its words. The vice president for monitoring viewed the primary purpose of these reports as supplying information to RISDIC's other vice president for use in scheduling examinations.[62] Neither vice president seemed to have a good, professional understanding of RISDIC's purposes in monitoring and examining its members--the very functions they supervised.[63]

In the case of Heritage, the quarterly financial data were chronically submitted months late. Data from the first quarter of 1990 (due at RISDIC on April 30) was never received from Heritage. Despite these signs <u>for at least a year</u> that something might be seriously amiss with the financial accounting records of Heritage, the only follow-up action appears to have been a friendly reminder by telephone that the information was late. The lateness of the quarterly reports from Heritage and the continuing high loan delinquency rate that they showed were known to both vice presidents,[64] but did not seem to prompt any specific corrective actions or extra attention on their parts.

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[62] Richer tr., pp. 3-4.

[63] Proto tr., pp. 25,29-30, 32-35; and Richer tr., pp. 11-20.

[64] Proto tr., p.14, and Richer tr., p. 23.

2. The Examination Process

RISDIC tried to coordinate tentative schedules of examination with DBR three to six months in advance. This policy was neither written nor was it formally communicated to DBR. The RISDIC vice president said he "psychologically preferred to stay away from [and] have the State do [the examinations of] the bigger institutions that were on the [RISDIC] board of directors."[65] RISDIC and DBR felt that they followed similar scopes for their examination of institutions because RISDIC's senior staff officers were formery DBR bank examiners. "We understood what we were looking for in exams."[66]

The numerous substantive tests outlined on RISDIC's standard "Scope of Examination" comprised a thorough review. However, this work program did not contain any special steps to check for compliance with applicable statutes or to assess insurance risk. Furthermore, workpapers for some of the examinations indicate that not all of the outlined tests were actually performed. There are no indications in the workpapers why these steps were skipped. Some RISDIC examiners were apparently more diligent than others in "signing off" when they had performed specific steps of the work program -- a common practice in the internal and external auditing professions. Although evidence of the supervisor's review is apparent on the drafts of the examination reports filed with the workpapers, such review is not indicated on the fieldwork papers

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65 Proto tr., p. 15

66 Paolantonio tr., p. 9

themselves and the vice president said it was not his practice to initial evidence of his review.[67]

Professional standards of both the American Institute of Certified Public Accountants and the Institute of Internal Auditors specify the need for auditors' professional proficiency, continuing education, and adequate supervision.[68] It does not seem that RISDIC's vice president in charge of examinations knew these standards or tried to implement them. He indicated that most of his staff needed little supervision or training because they had been at RISDIC a year or two longer than he had and "knew their jobs very well."[69]

None of the RISDIC employees had professional certifications common to the audit industry--Certified Public Accountant, Certified Internal Auditor, Chartered Bank Auditor, Certified Fraud Examiner, or Certified Information Systems Auditor--with the exception of one examiner who was licensed as a CPA in the early 1980's.

RISDIC's examination reports indicate that its examiners performed substantial work in many areas of their work program, and their lack of certification should not imply that their efforts did not result in important findings and recommendations in their reports. RISDIC was not obligated to test for compliance with all appropriate banking laws, or to draw the same conclusions from their examinations as DBR examiners. However, the

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[67] Proto tr., p. 21. Initialing workpapers is a technique auditors use to provide evidence of their adherence to several of the ten generally accepted auditing standards of the American Institute of Certified Public Accountants, or the five general standards and accompanying guidelines of internal auditing of the Institute of Internal Auditors.

[68] AICPA's Statement on Auditing Standards, No. 1., 1972, and the IIA's Standards for the Professional Practice of Internal Auditing, 1978.)

[69] Proto tr., p.18.

scope of their work was reported to approximate DBR's and DBR relied on RISDIC's examinations as if they were DBR's.

The RISDIC (and DBR) examination process was different from a CPA audit examination. For instance, RISDIC's examination process did not normally include independent confirmation of loan receivable balances (although this technique was used at Heritage once the suspicion of fictitious loans was roused by the out-of-balance condition and missing pieces of the loan records). The few written summaries of examination reports reviewed by this Commission indicate that the vice president of examinations provided RISDIC's president--who in turn presented their results to RISDIC's board of directors--with only minimal information (specifically, the CAMEL ratings) about member institutions. These summaries lacked the full commentary necessary to understand the ratings. Since the vice president and his staff never attended board meetings, it appears that any discussion about examination results would not be adequately informed.

Despite several shortcomings with RISDIC's examination process, it is not fair to say that lack of competence contributed to the collapse of RISDIC. It might be argued that RISDIC's examiners did not adequately test for adherence to sound and safe business practices, but the examiners were not trained or required to define such practices in any way other than that defined by statute, and the way RISDIC's board of directors might establish them by policy. The main problems with the examination process involved scheduling and resources. Given a fixed number of staff members and the fact that unforeseen problems inevitably arose, there was seldom enough staff to adhere to a desirable schedule. It was the

responsibility of DBR, not RISDIC, to ensure that some sort of regulatory oversight of RISDIC's members occurred annually.

3. Management Assistance

RISDIC staff examiners would occasionally be assigned to assist member institutions who required accounting or management expertise to help them address a specific problem. This form of assistance is commonly practiced by external and internal auditors, but separately from the audit function. In the instances known to this committee, RISDIC also made this distinction, except in one case. With Heritage, there seemed to be an inappropriate confusion of roles that RISDIC played as examiners on the one hand, and as managers and accountants for the institution on the other hand. RISDIC's interest in seeing that Heritage did not suffer losses inspired them to help Heritage solve problems that arose due to lax management. This interest compromised the independent examination and regulatory process in which they engaged, especially when RISDIC knew that DBR would be relying on its work. It also delayed by approximately four months the action that DBR would have taken if its own staff had examined Heritage in July 1990, as RISDIC's president and DBR's associate director had agreed would occur.[70]

D. RISDIC MEMBER INSTITUTIONS AND DEPOSITORS

1. A Primer on Sound Banking Principles

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[70]Hayes tr., pp.45-49.

Prudent behavior for banks can be summarized in a few guiding principles. Failure to observe these simple principles lies behind the current crisis. Many RISDIC institutions consistently violated these principles without suffering regulatory reaction.

• **Avoid overextension and quick growth.** The rapid expansion of its balance sheet can lead a bank to lend too much relative to its capital. It can also generate loans in areas of activity with which the bank's management is unfamiliar. The rapid expansion may arise because depositors are being offered deposit rates that are much higher than low risk lending can sustain.

• **Diversify loans to avoid lending a significant portion of bank capital to a single borrower or group of borrowers subject to the same credit risks.** A failure of a single company or problems in a single industry or locality can wipe out bank capital if there is insufficient diversification. Individual loans therefore should be limited to fractions of bank capital.

• **Avoid loans to borrowers connected to the bank.** Such loans may be to companies connected to the bank through a complicated corporate structure. They may be to the bankers themselves, to their friends and relatives, or to their political protectors. Loans of this sort can readily be used to strip the bank of its assets through some kind of fraud.

• **Avoid mismatching of liabilities and assets.** A typical mismatch occurs when a bank holds long maturity assets and short maturity liabilities. Then a rise in interest rates can wipe out bank capital and lead to collapse of the institution.

2. RISDIC Members in a Booming Market

In the five years before 1988, the Rhode Island economy enjoyed a boom. This was particularly true in the real-estate market, where values had been escalating for some time. The subsequent fall in real estate values eventually led to serious problems from non-performing assets for many commercial banks that had lent in ways that, in retrospect, were unwise. It is no surprise that these problems were similar or even worse for credit unions where personnel were less qualified to evaluate real estate-based loans, with the result that real estate developers and speculators obtained many large loans secured by questionable collateral.

From the mid-1980's, credit unions were competing directly with banks by offering higher interest rates and by providing insurance on deposits in excess of $100,000. In some cases, they were charging lower interest rates on loans and requiring far less rigorous documentation than was appropriate, certainly far less than that required by banks. These were heady times in the financial industry, and many credit unions went overboard by opening their formerly restricted membership to the general public and, in some cases, by violating their own rules governing amounts to be lent to an individual in relation to the credit union's capital.

With the relaxation of membership rules, it was possible for people to borrow from several credit unions without lenders' knowing that

multiple loans were being made to the same individual. In addition, there was extensive borrowing between credit unions that tended to obscure the institution's true financial condition.[71]

3. Rating Members

Bank examiners use a summary rating system to present an image of the condition of a bank. This system is known as CAMEL, an acronym derived from the dimensions of the institution that are considered most important: Capital, Assets, Management, Earnings, and Liquidity.[72] Bank examiners will give the institution a rating of from 1 to 5 in each of these categories, with 1 representing the highest quality. Examiners also give an overall rating to the institution. To understand these ratings:

Capital refers to the capital adequacy of the institution--that is, the cushion protecting depositors from fluctuations in the value of assets. For a credit union, book capital consists of retained earnings. In determining capital adequacy, examiners will deduct from book capital the value of questionable assets. If questionable assets exceed book capital, capital is definitely inadequate. The volume of risky assets is also taken into account in determining capital adequacy.

Assets refers to the quality of assets. Examiners determine three ratios: delinquent loans (loans that are substantially behind in payments) to total loans, non-earning assets to total assets, and classified assets (assets that

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[71]These practices demanded that credit unions exercise greater control and discipline over their operations than in the past. While DBR, RISDIC, and their own auditors were responsible for overseeing credit unions, the ultimate responsibility rested with their management and directors. Recognizing changes that were taking place in the financial markets and applying the appropriate internal controls was up to them. Many credit unions did this successfully, but others did not.

[72]This description of the CAMEL rating system is drawn from NCUA's RICUL Corporate Credit Union Report as of June 30, 1987. For a complilation of RISDIC-member CAMEL ratings, see Appendix 23.

are flagged as questionable) to total assets. If these ratios are excessive, asset quality is low. Consideration is also given to excessive concentration of loans among a few borrowers.

Management refers to the quality of management in operating the institution within accepted practices and in a safe and sound manner. It considers technical competence and management's ability to plan for the institution.

Earnings refers to the current net income of the institution. Examiners consider gross income and interest and operating costs relative to assets.

Liquidity refers to the cash needs of the institution. Liquidity depends on the nature of assets and liabilities. Examiners consider the maturity of assets and liabilities and the stability or volatility of deposit turnover. They also consider the marketibility of assets and the availability of lines of credit to finance temporary cash outflows.

The composite rating is based on the ratings in the individual categories. A rating of 1 means that the institution is sound in almost every area. Any problems are minor. A rating of 2 also indicates a fundamentally sound institution that has some problems correctible in the normal course of business. Supervisory response is limited in this case. A composite rating of 3 indicates a combination of weaknesses ranging from fair to unsatisfactory. The institution is only slightly resistant to the onset of adverse business conditions and could deteriorate. Such institutions need greater than normal supervisory intervention, but they are still strong enough that they are unlikely to fail. A composite rating of 4 indicates a set of weaknesses serious enough that strong action is necessary to avoid the institution's becoming non-viable. A probability of failure is present, and strong supervision is necessary. A composite rating of 5 indicates an institution with a high probability of failure. Urgent action is necessary.

At the time of its collapse, RISDIC's four largest institutions were Marquette, Greater Providence Deposit Corporation, Davisville, and Rhode Island Central. All but Greater Providence were credit unions. Shares and deposits at these institutions at the end of 1990 totalled $939 million. The growth of deposits at three of these institutions was rapid. In 1986, Marquette, Davisville and Rhode Island Central had deposits of $211 million, $71 million, and $82 million, respectively. At the end of 1990,

they had deposits of $334 million, $153 million, and $254 million, respectively. Rhode Island Central had tripled its deposits in four years. Greater Providence grew from $179 million in 1986 to $198 million in 1990.

Most of these institutions had long been of concern at DBR. As reflected in the CAMEL ratings received in DBR examinations, Marquette and Greater Providence had been troubled for much of the decade. "We were scared of the four big credit unions, and it goes back to 15, 20 years,"[73] according to one DBR employee.

Composite CAMEL Ratings from DBR Examinations
(1 is best; 5 is worst)

Year	Marquette	Greater Providence	Davisville	R.I. Central
1985		"4" (2/85)		"1" (12/85)
1986	"4" (3/86)	"4" (8/86)	"2" (4/86)	"1" (5/86)
	"3" (12/86)		"2" (12/86)	
1987	"2" (12/87)		"2" (12/87)	
1988		"4" (4/88)	"3" (12/88)	"1" (3/88)
1989	"2" (7/89)			"2" (11/89)
1990			"4" (3/90)	

Marquette's low ratings variously reflected poor capital, asset quality, and liquidity at different times. DBR ratings briefly improved at

[73]Paolantonio tr., p. 21.

the peak of the economic boom at the end of 1987. But the NCUA examination dated November 30, 1990, estimated a negative net worth of $30.1 million. Davisville's ratings fell seriously in 1988 due to the lowest possible rating on asset quality. The NCUA examination estimated in November 1990 that Davisville had a negative net worth of $17.7 million. Rhode Island Central received the best possible rating from DBR examiners through 1988. Yet from May 1986 to November 1989, outstanding loans tripled from $74 million to $218 million, and losses on these loans started to crop up. This led the DBR to downgrade its rating on asset quality from 1 to 3. The NCUA examination estimated that as of October 31, 1990, Rhode Island Central had a negative net of $18.5 million. In short, the three largest credit unions had negative net worths totalling $66 million according to the NCUA.

Among the "big four", Greater Providence is remarkable for having such consistently poor ratings, even in terms of book values. In every examination, Greater Providence received DBR ratings of 4. None of Greater Providence's five CAMEL ratings escaped poor scores, but Asset quality consistently earned ratings of 5. Delinquent and classified loans totalled $37 million in 1988 against book capital of $11 million. In 1985, Greater Providence's negative net worth may have reached upwards of $26 million. It is astonishing that DBR did not close the institution, and that RISDIC continued to insure it.

4. RISDIC's Promotional Activities

RISDIC promised security to its depositors. Indeed, "the incentive for creating RISDIC," according to a consulting firm hired by RISDIC in 1988,

"was provided by state-chartered credit unions who were looking for a marketing vehicle to attract additional depositors." [74] The marketing was originally limited to brochures and signage. Some of these materials featured the RISDIC seal, which bears a strong resemblance to the Seal of the United States (pictured on the back of the $1 bill). [75]

RISDIC enjoyed strong growth in membership and income between 1972 and 1980. But 1980 was the peak of RISDIC membership. The organization suffered a substantial decline in membership in the 1980's, ending the decade with only forty-five members. Obviously, these members would have to bear a larger burden if it ever came time to reassess the membership. Indeed, one of the proximate causes of RISDIC's collapse was the unwillingness of some members to accept another assessment on December 31, 1990.

The pressure on RISDIC reached a critical point in 1985, when RISDIC suffered its first drop in total deposits. Around this time, private thrift insurers in Maryland and Ohio collapsed, raising questions about other private insurers around the country. The NCUSIF reserve fund was bolstered through adoption of "the 1% solution" long used by RISDIC and other private insurers.[76] The RISDIC Board took a series of actions to counter the loss of members. These measures worked to increase total assets of insured institutions, but they did not prevent the loss of ten more members by 1989.

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[74] Milliman and Robertson, p.2.

[75] RISDIC's eagle carries only the talons of war, not the talons of peace; and the RISDIC seal lacks the "eye of Providence" that appears above the pyramid on the reverse side of the Seal of the United States.

[76] "The 1% Solution," Credit Union Magazine, December 1984, pp.46-8

In 1985, the Board adopted rules allowing accounts over $100,000. This eventually drew at least $166 million in deposits--the amount in accounts still frozen at the end of January, 1991. The Board also stepped up its political activities. At a special meeting of April 29, 1985, the Board of Directors engaged Mr. Maggiacomo as a 20-hour per week lobbyist. Information about political contributions by RISDIC during this time was not readily available to the study group.

Some of RISDIC's promotional efforts seem designed to create the false impression that there was a link between RISDIC and the federal government. Indeed, RISDIC's original name, The Rhode Island Share and Deposit Insurance Corporation, was so similar to the Federal Deposit Insurance Corporation, that the FDIC objected and RISDIC changed the word "insurance" to "indemnity". The implication of government backing remained, however, in a 1985 RISDIC brochure entitled "Answers to Important Questions." The words FEDERAL AGENCY are the only ones, other than RISDIC, highlighted in capital letters in this brochure. And the answers provided to certain questions include arguably misleading references to the United States Treasury and the the Federal Reserve, neither of which has a direct relationship to RISDIC. (See Appendix 13.)

Unsolicited correspondence received by Mr. Gregorian's office indicates that some depositors relied on these brochures. One particularly conscientious depositor sent an inquiry to Rhode Island Central's president about accounts exceeding $100,000. A reply from RISDIC's president included the representation that institutions with large accounts "must exceed the highest standards of our monitoring system requirements." This certainly was not the case with Heritage. It may, however, help to explain why five credit unions withdrew hundreds of thousands of dollars

from Heritage in early November, 1990--these deposits would not be considered insurable using the CAMEL-rating standard supposedly applied by RISDIC.[77]

RISDIC launched an expensive advertising campaign in 1985. The television ads featured the RISDIC seal and the claim that "our commitment to you is carved in stone." The RISDIC Annual Report does not indicate the cost of this campaign. RISDIC stopped including such details in its Annual Report earlier in the 1980's, when annual advertising expenditures rarely exceeded $10,000. RISDIC spent $220,000 on the advertising campaign in 1985.[78] Annual advertising expenditures apparently exceeded $100,000 in all subsequent years. The 1989 financial records indicate $134,869.27 in expenditures on advertising and public relations. Not all of these funds went to advertising, however, as one RISDIC employee indicated that political contribution were carried under this category.

E. AUDITS OF RISDIC

1. 1979 Assessment of RISDIC by Auditor General

On October 10, 1979, Anthony Piccirilli, Auditor General of the State of Rhode Island, transmitted his September 1979 Audit Report concerning

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[77] Heritage received a "3" in management in its 1987 DBR examination.

[78] On April 29, 1985, RISDIC approved a budget of $150,000 for advertising purposes for the period ending December 31, 1985. On September 4, 1985 the Board allocated another $70,000, still through December 31, 1985.

the Banking Division of the Department of Business Regulation to the Joint Committee on Legislative Affairs: Senators Joseph S. Gendron, Lila M. Sapinsley, Representatives Michael A. Higgins, and Frederick Lippitt. "Because of the close parallel between the activities and the Banking Division and the Rhode Island Share and Deposit Indemnity Corporation, we also conducted a limited review of the latter."[79]

The 1979 review of the Auditor General gave a clean bill of health to RISDIC:

> •The Corporation is adhering to sound fiscal policy, and the amount in the insurance fund is adequate to cover potential claims. In addition, the Corporation has the authority to make a special assessment against insured credit unions to make up any financial losses.
> •The examiners' staff is being expanded and upgraded, a move in which we strongly concur.
> •A good working relationship exists between the Corporation and the Banking Division as evidenced by numerous joint examination efforts . . .
> •The Corporation compares favorably with other state share insurance programs in all important aspects.[80]

However, in his findings and recommendations the Auditor General noted that:

> As part of our audit we reviewed the financial reporting

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[79] See Anthony Piccirilli, CPA, Auditor General's September, 1979, Report on Banking Division, p.1.

[80] See Anthony Piccirilli's September 1979 Report on the Banking Division, p. 16. The only problem the Report noted was the fact that "prior to 1978, income from investments was substantially lower than the industry-wide average. During 1978 investment policy was revised in favor of purchasing higher yielding U.S. Government obligations. The result has been a marked improvement in the ratio of total income generated compared to total assets employed."

practices of several credit unions. We noted that many of these institutions do not prepare their financial statements in accordance with generally accepted accounting principles as promulgated by the Financial Accounting Standards Board and the American Institute of Certified Public Accountants; while such financial statements may satisfy the internal needs of credit unions, they do not meet the standards required by external users including the Banking Division. This is especially true when there is a significant departure from generally accepted accounting principles resulting in the issuance of misleading financial data."[81]

2. DBR's Examination of RISDIC

According to Section II of the RISDIC Charter, "The Director of Business Regulation shall cause an examination of the books, assets, liabilities of the Corporation to be made regularly, at least once every two years, for which examination the Corporation shall be subject to the same supervisory powers of the Director of Business Regulation as are credit unions. . . ."[82]

As noted earlier, RISDIC was regulated as a banking entity rather than as an insurance entity. Just as DBR could rely on CPA-performed audits to satisfy its regulatory oversight of credit unions, it apparently relied on external audits of RISDIC to satisfy the comparable examination mandate.

The study group had access to one examination of RISDIC performed by DBR as of August 31, 1989, however, which purported "to determine RISDIC's compliance with applicable Rhode Island Banking Laws, RISDIC

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[81] ibid, p. 18.

[82] See RISDIC Charter, p. 4.

by-laws and charter procedures, policies, resolutions and prudent business practices."[83] The attachments to the report were financial statements and informative schedules about some of the balance sheet accounts for the eight-month period ending August 31, 1989; it is not mentioned whether or not the statements were prepared or examined for accordance with generally accepted accounting principles.

The report noted no violations, mentioned that "the fund balance was $28,891,934 or 1.88% of the insured deposits of $1,535,202,490,. . . all of the insured member financial institutions were in a positive capital position and none were on any type of assistance program."[84] It also assured that the impact on RISDIC's fund balance of refunding $2.2 million to former members of RISDIC in the coming year "should not be material."[85]

The examination report also made note of RISDIC's monitoring practices, stating that "RISDIC personnel receive quarterly monitoring information from all insured's, as well as monthly financial statements from most member institutions."[86] Apparently DBR either did not consider noteworthy the chronic delay of some institutions, particularly Heritage, in submitting their quarterly information during this time, or did

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[83] DBR "Report of Examination" on RISDIC, p. 1.

[84] Ibid.

[85] The financial statements attached to the report show that RISDIC actually held $3.6 million in non-member deposits at August 31, 1989. It could be argued that this entire amount should have been deducted from RISDIC's fund balance in determining what percentage of insured deposits the fund comprised since the non-members' deposits were no longer included in the denominator used for this calculation. Adjusting for this, the fund balance was more appropriately characterized as 1.65% of insured deposits.

[86] Ibid.

not realize that this was occurring. There was also no recommendation that the prudent business practice of monthly monitoring that RISDIC claimed elsewhere to be following, could have or should have been required for all member institutions.

3. CPA Audits of RISDIC's Financial Statements

RISDIC engaged an external CPA firm annually to perform an examination of RISDIC's financial statements. This was not required by RISDIC's charter or by-laws, but was a fiscally responsible action for RISDIC's board and management to take, and satisfied DBR's biannual examination requirement. From at least 1976 to 1981, the firm of Peat, Marwick, Mitchell & Co. performed the audit. Usually their opinion was "clean," but in 1981 they became aware of essentially insolvent conditions at some of RISDIC's members -- Marquette Credit Union in particular -- due to the rising interest rates being paid on deposits in contrast to relatively low, fixed-interest rates institutions were receiving on long-term loans. RISDIC management planned to work with Marquette to help the latter institution fix its problems.

Nevertheless, the professional judgment of Peat Marwick's auditors was that there was sufficient potential danger to the whole RISDIC enterprise if one of its insured institutions the size of Marquette were to go under and enough of a possibility that this could happen within the next year, that Peat Marwick qualified its opinion on RISDIC's financial statements for 1981. Peat Marwick noted in the qualification paragraph the problems with the interest rate environment as it affected thrift institutions, and that RISDIC did not provide for potential losses and

liquidation expenses in its financial statements. (See Appendix 14 for full text of opinion.)

The following year, RISDIC engaged a different audit firm, Arthur Young & Company (Ernst & Young since 1989), which audited RISDIC's financial statements for each year 1982 through 1988 and issued a "clean" opinion each year. Information about RISDIC management's practice not to record reserves for potential but nondeterminable losses was disclosed in the footnotes to the financial statements rather than in the auditor's opinion itself. The practice not to record such losses was an allowable treatment under generally accepted accounting principles.[87] The option to disclose this subject only in the financial statement footnotes rather than qualifying the audit opinion is allowable under generally accepted auditing standards.[88] The fact that Arthur Young & Company did not qualify its opinion implies that the firm was persuaded by RISDIC management and the information they reviewed that the potential for one of RISDIC's members to fail was too remote to justify qualifying their opinion.

Without access to the external accounting firm's workpapers, however, it is impossible to assess if the necessary audit steps were taken to justify Arthur Young's reaching this conclusion each year, particularly in the face of Peat Marwick's qualification. Had the 1981 opinion qualification been repeated in subsequent years, it is possible that it would have provided a chink in the armor of RISDIC's arguments against the legislation proposed in 1986 to require federal insurance.

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[87] State of Financial Accounting Standard No. 5, "Accounting for Contingencies," issued by the Financial Accounting Standards Board in March, 1975.

[88] Statement on Auditing Standard No. 2, "Reports on Audited Financial Statements," issued by the American Institute of Certified Public Accountants in October, 1974.

For the year 1989, Ernst & Young dual-dated their opinion on the financial statements, making special reference by the latter date of circumstances regarding a loss at Jefferson Loan & Investment Company which RISDIC knew by early 1990 it would have to insure. Appropriately, Ernst & Young required RISDIC 's financial statements to reflect this estimated loss.

Arthur Young & Company did not make it a practice either to sign an engagement letter with RISDIC each year, meet with the Board of Directors of RISDIC to discuss the results of the audit, or issue management letters that discussed problems that had been noted during the audit and corresponding recommendations for improvements. Although these practices were recommended ones in the accounting industry during the 1980's, none of them was required by generally accepted auditing standards. Effective January 1, 1989, auditing standards were revised considerably. Among other things, they required different wording of standard opinions, recommended written communications of matters noted in an audit, and required communication of certain matters to audit committees or boards of directors.[89] It does not appear that Ernst & Young adjusted their practices to improve communications with RISDIC's directors, as might have been expected for their audit of RISDIC's 1989 financial statements.

F. RISDIC BOARD OF DIRECTORS

[89] Statements on Auditing Standards #58, 60, and 61, issued by the American Institute of Certified Public Accountants, 1988.

The RISDIC Board of Directors consisted of not less than fifteen representatives from member institutions and not more than three "public" directors.[90] Primary operational decisions were made by a five-member executive committee of the board, which consisted of the chairman, two vice-chairmen, the secretary, and the treasurer.[91] A review of the board's meeting minutes over the years indicates that the executive committee regularly met in advance of any general board meetings, and that the full board consistently followed executive committee recommendations. Members of the board received $250 per month regardless of whether they attended that month's board meeting. Members of the executive committee were paid $450 per month, and the chairman received $650 per month.

Board members had little contact with the process or results of individual institutions' examinations. Neither the members of the Board nor the Executive Committee ever looked at RISDIC's examination reports of its members. The Board relied entirely on RISDIC president Peter Nevola's summaries of member examination reports. Without specific access to the individual examination reports, members of the Board relied upon the president to alert them to problems that required Board attention.[92] One member of the executive committee stated that he knew he was operating his institution properly, and he presumed that other

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[90] RISDIC By-laws, Article IV Section 1.

[91] RISDIC By-laws, Article IV, Section 2.

[92] Eugene Leco tr., p. 6.

institutions were being run properly as well.[93] Individual board members knew when their own institution had been audited, and may have presumed that other member institutions were audited with equivalent regularity. No schedule or "scorecard" of examinations was ever presented to the board. [94] With regard to audits or examinations of RISDIC itself, some board members did not recall receiving reports from RISDIC's external auditors. Moreover, the board had no audit committee assigned to review the work of the external auditor or to assure management's compliance with the auditor's recommendations.

The structure and composition of the RISDIC board may have contributed to the institution's downfall. Its board of directors was made up almost entirely of the chief executive officers of many of the credit unions which it insured, and there was the potential for conflict of interest. Conflict of interest can be defined as a person being in a situation in which he or she has loyalties to two separate organizations which have or may have competing interests. RISDIC's board presents a perfect example of such a conflict since it represented the organizations which it was supposed to oversee.[95] This posed two obstacles to the appropriate conduct of RISDIC's business. First, since part of RISDIC's function was to regulate the conduct of the organizations which it was insuring, it placed RISDIC staff in an untenable position. If, in the course of performing their regulatory functions they were to exercise appropriate discipline for one of

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[93] Paul Fillipone tr., 25.

[94] George Staffopoulos tr., pp. 8-9; Stephen Kowalik tr., p. 19.

[95] One board member stated that he felt he was on the RISDIC Board to represent his own credit union. Leco tr., p. 10.

RISDIC's insured members, they might be treading on the toes of one of RISDIC's directors. Secondly, none of the directors who were chief executive officers of a RISDIC-insured entity was willing to build up RISDIC's reserves to the extent that could have been done, or to assume major losses of other member institutions, since such action would have diminished the capital and earnings of that director's organization.

Particularly with regard to the examination of member institutions and RISDIC itself, the board appears to have been a captive of management, with few mechanisms in place to assure management's competent execution of RISDIC's functions. For example, after making payments on the losses at Heritage, the board clearly had the power to raise additional reserves by making assessments from the member institutions. As one former external auditor pointed out, however, the more RISDIC assessed its individual members, the weaker each became.[96] Thus, even in the abstract, the board's power to impose supplemental member contributions was problematic. Moreover, in time of actual or threatened "runs" at several institutions, board members were placed in a position of weighing their own institutions' need to preserve capital against RISDIC's need to replenish its reserves. It seems unlikely that any individual board member could properly weigh that choice without risking abdication of his fiduciary duty to RISDIC or his own institution.

Without access to information in individual examination reports, with no supervisory view of the scheduling of examinations, with neither an audit committee nor any other mechanism to review management's conduct, RISDIC's Board was ill-equipped to foresee the type of problems

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[96] Karl Ericson tr., p. 10.

that occurred at Heritage. Moreover, the inherent conflict that accompanied board membership obstructed the directors' theoretical ability to replenish RISDIC's reserves and rendered RISDIC unable to recover from serious losses, whatever their source. It is significant that the Board was dominated by the very institutions that were unable to qualify for federal insurance and reopen in January, 1991.

G. LIQUIDITY AND THE ROLE OF THE RHODE ISLAND CREDIT UNION LEAGUE'S CORPORATE CREDIT UNION

1. Liquidity Provision vs. Deposit Insurance

Although RISDIC claimed to be an insurer and not a liquidity provider, it acted otherwise in the case of Heritage. An understanding of the distinctions between liquidity provision and deposit insurance is needed to analyze the role of the Rhode Island Credit Union League's Corporate Credit Union (RICUL-CCU) in the RISDIC system, and to recognize the misunderstandings inherent in some of the arguments over federal insurance in 1986, and to assess the options that were available to RISDIC in 1990 when some of its members faced liquidity crises.

Financial institutions require access to liquidity to meet unusual and temporary imbalances in cash flow. Institutions in a banking, S&L or credit union system can meet cash outflows by holding cash or liquid investments that can serve as collateral against credit lines from banks, establishing secured or unsecured credit lines with other similar institutions, or accessing cash from sources external to the system. Cash

flow imbalances may be chance or seasonal phenomena or, ominously, they may result from a run caused by lack of confidence by the creditors of the institution. In the most extreme case, financial intermediaries seek access to liquidity on a large scale as a device to protect themselves against a run caused purely by a "contagion of fear" among depositors. In such a case, it is standard practice to choke off a run by demonstrating that the institution can 'cash-out' deposits in effectively unlimited amounts.

Liquidity is distinct from deposit insurance, however. The deposit insurer guarantees the capital value of deposits and thereby creates confidence in depositors that they will not suffer loss from a failure of their deposit institution. Typically, when financial institutions fail, deposit insurers quickly allow depositors to access their deposits, so that depositors will suffer neither capital loss nor a temporary loss of their own liquidity. With confidence in the deposit insurer, depositors will not 'run on' their institution, and the institution, in turn, may need less access to liquidity to cover such an extreme event.

If it has high quality assets to secure lines of credit, an insured intermediary can be liquid -- that is, able to meet day-to-day cash flow imbalances -- for a long time, even though it is insolvent. Since depositors lack the incentive to run and force the closure of the institution, the deposit insurer must eventually act to protect the insurance fund against further loss. The insurer has several options:

1. A payoff of the insured depositors and closure of the institution.
2. A purchase and assumption in which another institution purchases some of the failed institution's assets and assumes the deposit liability along with a cash injection by the insurer.

3. A deposit transfer in which the insurer makes a cash payment to another institution to accept responsibility for deposit liabilities. The remainder of the institution is liquidated by the insurer.
4. A bailout of the institution -- that is, financial assistance to the institution to prevent its failure and permit its continued operation as an independent entity.
5. A bridge institution owned by the insurer to operate the failed institution temporarily until its final disposition can be determined.

The insurer chooses an option that minimizes its potential losses and the disruption to the customers of the institution. If a payoff is chosen, the insurer becomes the receiver of the closed institution and immediately writes checks fully repaying the insured depositors. Alternatively, the insurer may simply transfer the insured deposits to another institution along with the cash to cover them.

In a bailout, the insurer injects sufficient cash into the failing institution to cover the difference between the estimated market value of the institution's assets and its liabilities. It then finds private investors to inject new capital into the institution. The old management is usually replaced with new external management. Unlike the other methods, the institution never formally closes or ceases business activity.

Finally, the insurer may charter a bridge institution to take over the assets and some liabilities of the closed institution. The insurer itself owns the bridge institution, pending the final disposition of the failed institution. The bridge institution option allows the insurer to prevent the damage to a

community that terminating the operation of an institution might cause while avoiding the moral hazard of operating a failed institution with negative capital. In this instance, the difference between deposit insurance and liquidity provision is blurred since the insurer's resources now serve as the ultimate source of liquidity to the still-operating institution.

2. Liquidity and Deposit Insurance for Banks and S&L's

Deposit insurance and access to liquidity are separate services that are usually provided by different institutions, whether in the commercial banking system, the thrift system (savings & loan institutions, or S&L's), or the credit union system. In the banking system, liquidity for larger banks arises first from interbank lending in the federal funds market. In addition, the Federal Reserve supplies liquidity to banks directly through discounts and advances through the discount window or repurchase agreements for Treasury securities, and indirectly through open market purchases of Treasury securities.

The Federal Home Loan Banks (FHLB), formally owned by S&L's though controlled by the federal government, provide liquidity to the S&L's in a manner analogous to the Federal Reserve. S&L's borrow from the FHLB to cover deposit outflows. The FHLB, however, funds itself by selling its own obligations on the open market, in contrast to the Federal Reserve which monetizes debt.

Both commercial banks and thrifts obtain deposit insurance through the Federal Deposit Insurance Corporation (FDIC).[97]

3. Liquidity Provision for Credit Unions

Credit unions developed their own national system for the provision of liquidity. Of course, credit unions also maintain cash holdings and liquid investments that can be used in drawing lines of credit from commercial banks.

In addition, credit unions engage in inter-credit union lending in several forms. First, credit unions with surplus funds may make deposits in other credit unions. Second, each state has a corporate credit union in which credit unions can deposit excess funds or borrow funds. The corporate credit unions also extend lines of credit to their members (which are both state and federally-chartered credit unions), and provide other services such as check-clearing. The RICUL Corporate Credit Union is the corporate credit union for Rhode Island. In turn, the state corporate credit unions are members of the U.S. Central Credit Union, in which they make deposits and from which they can obtain loans through credit lines.

The corporate credit unions only redistribute liquidity among the credit unions. To supply liquidity from outside the credit union system, the Board of the National Credit Union Administration (NCUA) manages the Central Liquidity Facility (CLF), designed to serve as a central bank and lender of last resort. The CLF channels liquidity directly to federal or

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97 Until it was subsumed by the FDIC, the Federal Savings and Loan Insurance Corporation (FSLIC) insured S&L deposits.

state-chartered credit unions or indirectly through corporate credit unions that serve as agents for their own members.[98] The CLF charges above-market rates for short term credit. This revenue is used by the CLF to subsidize relatively longer-term collateralized loans to problem credit unions. The CLF requires capital subscriptions of its members and is itself funded by the Federal Financing Bank, which finances U.S. agency securities with securities backed by the full faith and credit of the U.S. government.

4. RICUL-CCU as a Liquidity Source for RISDIC Institutions

RICUL Corporate Credit Union, whose president is Robert V. Bianchini, is the main source of liquidity for both federal and state-chartered credit unions in Rhode Island. Rhode Island credit unions maintain deposits with RICUL-CCU which, in turn, deposits the bulk of the funds with the U.S. Central Credit Union. Most of the remainder of assets are loans to the members who have drawn on their lines of credit with RICUL-CCU. RICUL-CCU's assets are highly liquid with the majority in the form of overnight deposits. As a result, the amount of RICUL-CCU's assets fluctuates as its members add to or draw down their liquid deposits. Assets ranged from a high of $213 million on June 30, 1986 to $113 million on December 31, 1987.[99] In January, 1991, its assets were about $200 million.[100]

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[98] In 1988, the CLF had 266 direct credit unions members and 42 agent members representing another 15,500 credit unions. (Alane K. Moysich, "An Overview of the U.S. Credit Union Industry," FDIC Banking Review, Fall 1990, pp. 12-26.)

[99] NCUA Examination Report on RICUL-CCU as of 10/31/88, p. 6.

[100] Bianchini tr., p. 20.

RICUL-CCU's capital is about $1.5 million.[101] In its examination, NCUA gave RICUL-CCU a low rating on its capital relative to assets, finding it below the norm for corporate credit unions.[102]

RICUL-CCU provided contractual lines of credit amounting to $416 million to its members and had a credit line of $55 million from the U.S. Central Credit Union.[103] It also had a line of credit from the Central Liquidity Facility of $50 million.[104] In its most recent examination report, NCUA stated, "There appears to be no business plan which would permit this credit union to fund the approved lines if called upon to do so." Of the credit lines to members, thirty exceeded the total capital of RICUL-CCU and twenty-one exceeded $5 million. The NCUA report stated that it was not prudent for RICUL-CCCU to offer such lines, given its size and capital. "Existing lines of credit approved for member credit unions were influenced by the needs of those credit unions to comply with then existing law." Thus, RICUL-CCU provided its state-chartered members large credit lines so that, on paper, they could comply with legally-mandated liquidity levels, although RICUL-CCU's own regulator pointed out that the magnitude of such lines was not realistic. NCUA's examination report further stated, "The corporate should be concerned with those credit unions which do not have either internal or outside audits completed and should consider the absence of such when establishing a line of credit."

NCUA also expressed its uneasiness with RICUL-CCU's excessive credit lines to state-chartered members in its examination reports as of

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[101] NCUA Examination Report on RICUL-CCU as of 1/31/90. NCUA treats retained earnings as capital.

[102] NCUA Examination Reports on RICUL-CCU, as of 6/30/87, 10/31/88, and 1/31/90.

[103] NCUA Examination Report on RICUL-CCU, as of 1/31/90, p. 3.

[104] Bianchini tr., p. 29.

June 30, 1987 and October 31, 1988. In the 1987 report (delivered in January, 1988) it stated that the then-outstanding $372 million in lines of credit to members was excessive. In the 1988 report, it specifically criticized the size of the credit line to Rhode Island Central Credit Union, a line of $70 million.[105] It stated that this was an unreasonable amount to extend to any one borrower, since it represented 43% of RICUL-CCU's assets and 700% of its reserves. At the time, R.I. Central had an outstanding loan of $18.2 million on the line.[106] On November 30, 1989, the credit line to R.I. Central was $55,000,000.[107] By December, 1990, R.I. Central's line had declined to $39.5 million;[108] but, as predicted by NCUA, RICUL-CCU could not meet R.I. Central's liquidity demands of even half this amount.[109] By December 31, 1990, Rhode Island Central's credit had been cut to $20 million at the direction of the NCUA.

In addition, RICUL-CCU extended major lines of credit to several other RISDIC-insured credit unions: $14 million to Columbian, $22 million to Davisville, and $60 million to Marquette.[110]

To lend on these credit lines, RICUL-CCU could either use its own resources or tap its own credit lines at the CLF or the U.S. Central Credit Union. For RICUL-CCU to access these lines on behalf of the RISDIC institutions, the NCUA required that all loans be secured by securities

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105 NCUA Examination Report on RICUL-CCU, as of 10/31/88, Supplementary Facts, p. 3.

106 The 1988 report does give RICUL-CCU a high rating for liquidity, stating that in spite of comments about lines of credit, there appeared to be no immediate problem with its own liquidity. A similar assessment appeared in the 1990 report.

107 DBA Examination Report on R.I. Central, 11/30/89, p. 4.

108 Ruggieri tr., p. 13.

109 Bianchini tr., p. 28.

110 DBR Examination Reports on Columbian Credit Union (6/30/90), Davisville Credit Union (3/31/90), and Marquette Credit Union (7/31/89).

deliverable through RICUL-CCU to the CLF or U.S. Central.[111] In fact, because of the nature of their balance sheets, RISDIC members lacked sufficient assets to collateralize more than a fraction of their credit lines through the CLF and U.S. Central.

RICUL-CCU's president recently claimed that he had been unaware then that RICUL-CCU could not use assets of the sort held by RISDIC members (e.g., commercial loans and inadequately documented real estate loans) to collateralize loans through the CLF.[112] Furthermore, RICUL-CCU's lending on the basis of its own resources to RISDIC members was limited during December, 1990 by intervention of the NCUA. Hence, RICUL-CCU's promised liquidity support for the RISDIC-insured institutions was an illusion.

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[111] Bianchini tr., p. 29.

[112] Ibid., p. 38. In the Finance Committee Hearing on May 12, 1986, Bianchini pointed out the great access to liquidity of RISDIC members, stating that the CLF would lend up to 90% of the assets of a credit union (in interchange with Stitt).

SECTION II: THE BRANCHES OF STATE GOVERNMENT

A. THE GENERAL ASSEMBLY

A review of legislation concerning RISDIC and its members reveals a strong relationship between RISDIC and the General Assembly. Former Senator John D'Amico described RISDIC's lobbying power as "tremendous." [113] Senator D'Amico referred specifically to financial contributions and support in election campaigns, including the use of phone banks in credit union offices. [114] Former Director of Administration, and former House minority leader Frederick Lippitt said that credit unions had powerful influence in the legislature. [115] Former Representative Elizabeth Morancy described RISDIC as part of an "old boy" network, with no one in the General Assembly willing to view them objectively or critically. [116] Former DBR Director Robert Janes aptly characterized RISDIC as "the darling of the General Assembly."[117]

RISDIC certainly had powerful friends in positions of leadership in the Assembly. Senator John F. Correia, an officer of the East Providence Credit Union, was chairman of the Senate Corporations Committee when it considered the federal insurance bill in 1986. Representative Joseph

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[113] D'Amico, tr. 12.

[114] D'Amico, tr.13.

[115] Lippitt, tr. 14.

[116] Morancy. tr. 2-3.

[117] Janes, tr. p. 38.

DeAngelis, currently Speaker of the House, told this commission that he was "not very familiar with RISDIC" [118] Nevertheless, he sponsored several pieces of legislation relative to RISDIC and its members. He has also served as counsel to Union Deposit Loan and Investment Bank & Trust of East Providence, a RISDIC member.[119] He personally appeared before RISDIC's board in that capacity.[120] His law firm represented some of the individuals interviewed by Mr. Gregorian. Steve Kowalik, an officer of West Warwick Credit Union, and Director of RISDIC, served as Representative Tucker's campaign treasurer from 1984 to the present. Representative Joseph Casinelli introduced legislation on behalf of RISDIC.[121] He also served on the Board of Bank Incorporation. Representative Robert Bianchini served as Vice-Chairman of the House Finance Committee and presided during portions of the 1986 hearing on federal insurance. He also served as chief executive officer of the R.I. Credit Union League and its Corporate Credit Union. In that capacity, he frequently attended RISDIC Board meetings.

Since its inception in 1969, RISDIC and its member institutions were indulged by the General Assembly on numerous occasions.

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118 DeAngelis tr., p.5.

119 DeAngelis tr., p.42.

120 RISDIC Board Minutes, November 9, 1982.

121 Representative Casinelli, although not a member of the House Finance Committee, arranged a special dinner meeting of that committee in 1986 at the Aurora Club, to discuss the Gaschen-D'Amico federal insurance bill. (Morancy, tr. 5-10). Casinelli took an active role at the meeting, which included presentations by RISDIC President Nevola and Representative Bianchini. (Morancy, tr. 9-10) In 1990, Representative Casinelli introduced House Bill No. 90-H-4098, which would have permitted RISDIC to operate a financial institution, for an apparently unlimited amount of time. BBI Approval was required, but all of the proceedings were to be in secret. The bill passed the House on June 21, 1990, but was defeated in the Senate on July 3, 1990. A copy of this bill is reproduced in Appendix 15.

Among other bills that broadened the activities of RISDIC's members, Pub. L. 1971, ch. 262 authorized, credit unions to engage in so-called "participation loans." In 1972, the legislature authorized Rhode Island chartered credit unions to invest in out-of-state mortgages [122]. In 1976, in legislation introduced by William Babin, a RISDIC Board member, the General Assembly amended RISDIC's charter to permit it to insure banks and other financial institutions. [123] This opened RISDIC to Greater Providence, Heritage, and ultimately Jefferson. In 1979, the Legislature modified an elaborate formula requiring the establishment of special reserves against loss, delegating to the directors of the members and DBR the discretion to impose such reserves [124]. In 1986, in legislation introduced by Representative DeAngelis, RISDIC's mission was expanded beyond insurance to providing "financial analysis, examination, monitoring, and services related thereto..."[125] The 1986 bill also permitted RISDIC, which had been restricted to investing in securities, to invest its funds in any investments legal for Rhode Island banks.

In retrospect, one of the most significant legislative developments came in 1980, with the adoption of Pub. L. 1980, ch. 196, sec. 3. That act modified the statutory requirement for an annual DBR examination by permitting DBR to accept an examination prepared by RISDIC in lieu of the DBR's own examination. By enactment of this statute, the Legislature

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[122] Pub. L. 1972, ch. 216.

[123] 1976 Acts & Resolves 40, sec.1

[124] Pub. L. 1979, ch. 51.

[125] 1986 Acts & Resolves 39, sec. 1

conferred substantial regulatory authority and responsibility upon RISDIC. A 1981 statute introduced by Senator Quattrocchi allowed loan and investment companies to call themselves banks. [126]

Indicative of the changes in the character of credit unions was the substantial loosening by the Legislature of the limitations on corporate or business entity membership in credit unions. Specifically, sec. 19-21-3, defining membership, was amended to eliminate the language in brackets below:

> **19-21-3. Membership of associations and corporations.** -- After organization of any such credit union has been completed, nothing contained in this chapter shall be construed to debar from membership any fraternal organization, voluntary association, partnership or corporation [having a usual place of business within the state and composed principally of members or stockholders who are themselves, individually, eligible to membership in such credit union].

The same 1985 legislation eliminated the requirement that the supervisory committee conduct an audit prior to the declaration of any dividend.

In 1986, the General Assembly took up consideration of the so-called D'Amico-Gaschen bills that would have required federal insurance for all deposit-taking institutions. (The Assembly's failure to enact that legislation is discussed later in this report.) In 1986 the Assembly enacted a bill sponsored by Representative DeAngelis, which required all credit unions to maintain liquidity reserves of 5% and lines of credit totalling 20% of total assets.[127] In 1986 a bill introduced by Representative Casinelli modified

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[126] P.L. 1981, ch. 357 (codified at R.I. Gen. L. sec. 19-20-27).

[127] Pub. L. 1986, ch. 384.

these requirements, reducing the minimum reserves to 15 percent. This legislation came shortly after the NCUA had issued its 1987 report critical of RICUL Corporate's excessive lines of credit, particularly to RISDIC members, and questioning RICUL Corporate's ability to fulfill them.[128] In its supplementary facts, the report singled out seven RISDIC credit unions with RICUL-CU credit line that did not provide timely financial information. With their maximum lines of credit, these were Columbian-$15 million, R. I. State Employees-$25 million, Central-$3.5 million, R.I. Central-$30 million, Marquette-$60 million, Heritage-$2 million, East Providence-$25 million.

The report stated, "Effective 7/1/86 all State chartered credit unions are required to obtain a line of credit equal to 20% of the assets of the credit union (RI Statute19-21-55). As of 6/26/87 the RICUL Corporate Credit Union has approved lines of credit to member credit unions totalling $372,045,000 to enable those credit unions to comply with that requirement. However, at the present time the Corporate would not appear to be able to fulfill its obligation to fund all of these lines of credit, if such became necessary, unless other options become available or existing credit lines are adjusted."

RISDIC's warm relationship with the General Assembly is further illustrated by the legislature's unwillingness to adopt measures or controls inconsistent with RISDIC's wishes.[129] For example, the General Assembly could have required annual examinations for RISDIC members. Instead,

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[128]NCUA RICUL Corporate Credit Union review report as of June 30, 1987.

[129]One DBR member stated that the credit union lobby frequently "killed' bills that would have imposed further regulation. Pare tr., pp. 34-40.

examinations were required only every three years, and only for institutions larger than $10 million. In 1981, the General Assembly failed to pass a bill that would have allowed another private insurer to operate in competition with RISDIC.

Several of those interviewed have identified structural problems in the General Assembly that likely contributed to the legislature's failure to control RISDIC and its members. Some of these issues merit public consideration and attention.

1. Part-time Legislature and Potential Conflicts of Interest.

The Rhode Island General Assembly consists of the Senate and the House of Representatives. Unlike their counterparts at the federal level and in many other jurisdictions, members of the General Assembly receive only nominal compensation for their service. Thus, the General Assembly is purely part-time, and members depend for their income upon their regular, full-time employment. Because virtually all legislators have outside employment, the possibility of conflicts of interest is greatly increased. Because there are no stenographic transcripts of committee hearings or other proceedings, this Commission was not able to study this problem in any detail. Based on a review of a video tape of the 1986 hearing in which the House Finance Committee considered a bill that would have required RISDIC institutions to transfer to federal insurance, it appears that these problems are widespread and serious.

One glaring example involves Representative Robert Bianchini, the vice-chairman of the committee, who was also chief executive officer of the Rhode Island Credit Union League (RICUL). Several interviewees have identified the League as a "trade association." Many RICUL members

would have been directly affected by the legislation. (Others already had federal insurance.) Yet Representative Bianchini not only participated in the hearing, he presided over portions of it. A review of the tape reveals that, as some of the witnesses offered their views to the committee, Representative Bianchini, from the committee dais, offered responsive information. To the observer, his role in the hearing shifted at times from questioner to advocate. Indeed, a simple majority of the Conflict of Interest Commission voted to find Representative Bianchini in conflict, but this vote was inadequate to sustain any action against him.[130]

The Commission does not intend to single out Representative Bianchini. That hearing was the only one that the Commission had the opportunity to review on videotape. The Senate Corporations Committee considered a similar bill in 1986. Senator Correia apparently presided at that hearing, while he was an officer of a RISDIC-insured credit union.

The foregoing examples are for illustration only and are clearly not an exhaustive survey of conflicts or potential conflicts in the Assembly. Other possible conflicts of interest came to the attention of the Commission. Several members of the General Assembly are attorneys; some DBR staff members expressed concern that members of the General Assembly sometimes represented clients in meetings with DBR. A former DBR director suggested that certain members of the General Assembly have significant influence on the pay level of the Department Director, and that this can have an intimidating effect when a member of the General Assembly is acting as advocate for a client before his Department. Related

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[130]Morancy tr., p. 17-18.

concerns occur when a member's law partner represents an individual or entity with an interest in a particular matter before the Assembly.

2. Lack of Staff

Members and committees of the General Assembly are without substantial staff assistance in the course of their deliberative process. Members of Congress and some other state legislators depend upon substantial staff work in connection with pending bills; members of the General Assembly rely upon their own, part-time efforts in reviewing legislation. This lack of staff support can cause two problems. First, a member with expertise in a particular field is likely to hold substantial influence when matters come before the assembly that relate to his or her speciality. Members would turn to an individual member with specialized knowledge of credit unions, for example, because that member's expertise and knowledge would be the only source of information regarding the topic available within the legislative branch. The influence of that member might well dominate other legislators who lack the time or resources to challenge the positions taken by the specialist-member. Second, the absence of staff in the General Assembly may also tend to enhance the influence of lobbyists. In the pure sense, lobbying consists of supplying members with information in support of a particular cause pending before the legislature. Without staff, the member may come to rely upon the lobbyist as the only source of specialized or detailed information concerning a particular piece of legislation.

B. THE EXECUTIVE BRANCH

1. Governor

Since 1971, RISDIC's authority was expanded many times by the General Assembly. Several bills were enacted that strengthened RISDIC at the expense of DBR, and the Executive Branch was either unable or unwilling to counter these measures. By the time Governor DiPrete was elected, RISDIC was a major economic and political force.

Governor DiPrete first confronted the RISDIC lobby in 1986 when bills were proposed to mandate federal insurance for all RISDIC members. Governor DiPrete endorsed the bills introduced by Senator John D'Amico and Representative Francis Gaschen. The Governor supported additional legislation suggested by his special counsel, Normand Benoit, to strengthen the regulatory powers of DBR, and limit the practice of "insider loans." Governor DiPrete also called upon members of BBI, specifically Attorney General Arlene Violet, to lend their cooperation and support of his legislative package, and directed Mr. Benoit to testify on behalf of his administration. According to Governor DiPrete, the credit union lobby was "the most powerful influence within the General Assembly" and in response to these proposals, the Democratic leadership of the General Assembly "laughed at us." After the defeat of the D'Amico-Gaschen bills, portions of the governor's legislative package were approved, but in substantially watered-down form.

Chastened by this defeat, Governor DiPrete did not reintroduce any further legislation concerning federal insurance during the balance of his

tenure because he was worried in part that a public debate of RISDIC might precipitate a crisis in public confidence in Rhode Island's financial institutions. The Commission can not understand, however, why no other steps were taken by the Governor to strengthen the state's regulatory authority over RISDIC and its insured members, such as ordering the DBR Director to make active use of existing cease-and-desist powers to prevent RISDIC-insured institutions from engaging in unsafe and unsound practices and/or developing one of the emergency plans recommended by his own Special Counsel.

2. Attorney General

Based on interviews of Governor DiPrete, Attorney General O'Neil, and other officers of the state government, the Commission was dismayed by the failure of the various executive officers to work closely together on the matter of protecting the depositors in RISDIC's member institutions. For example, Governor DiPrete pressed for his own investigation into the collapse of Heritage because he believed Attorney General O'Neil was "foot-dragging" in looking into whether organized crime was involved in Heritage and whether certain depositors used "inside information" to make last-minute withdrawals. Attorney General O'Neil, who already had his own investigation under way, criticized the Governor, calling the Governor's investigation "an obstruction of justice."

The State of Rhode Island is unique in that it assigns to the Attorney General duties as a member of the five-member Board of Bank Incorporation. It was in that role that Attorney General Violet testified on behalf of the Gaschen Bill in 1986. As Attorney General, she authorized the Stitt-Black Report of December 13, 1985. Because of the sensitive

nature of the Report, she forwarded it on a confidential basis to the Governor and urged him to take action. Although she declined to be interviewed, it appears from information available to the Commission that the former Attorney General sent a copy of the report to then-Treasurer Roger Begin, a fellow member of BBI, but not to the other members of BBI, which included the Director of DBR and representatives of the Senate and the House.

The Commission is surprised that, knowing the importance and sensitivity of the Stitt-Black Report, General Violet did not raise the report with fellow members of BBI, or press the matter further with either the Governor or the Chairman of the House Finance Committee, Robert Tucker, who had taken "under advisement" her offer to share the report with the Finance Committee in executive session.

By all accounts, the transition from the Violet Administration to the O'Neil Administration was not a smooth one. Attorney General O'Neil's spokesman acknowledged that "Violet's staff left the RISDIC Report behind when she left office, but never directed O'Neil's attention to it." The spokesman added that he "did not know when it was discovered or when O'Neil read it." Attorney General O'Neil confirmed this in his interview by the Commission. It is unfortunate that, in his capacity as a member of BBI, O'Neil did not take up the issues raised in the Stitt-Black report. The Commission regrets that there was no continuum in the policies of the two administrations.

Even though the Commission appreciates that Attorney General O'Neil recused himself in matters before the BBI concerning Jefferson Loan and Investment Company, in which his campaign manager Cerilli had an interest, it is not clear what role, if any, O'Neil's office played during the

collapse and aftermath of Jefferson. What is clear, however, is that when Nancy Mayer, Chief Counsel of DBR, asked Assistant Attorney General Gorman to look into irregularities at Jefferson, she was turned down and told that the Attorney General's Office did not deal with "white collar crimes."

3. General Treasurer

The General Treasurer is, among other things, in charge of investing all of the State's funds, including its multi-billion dollar pension fund. The Treasurer is also a member of the BBI, increasing the duty to protect the soundness of financial institutions.

Former General Treasurer Roger Begin, now Lt. Governor, indicated during his interview that he had concerns for many years about the strength of RISDIC and the health of some of its insured institutions. He told the Commission that he favored BBI hearings in 1986 on the issue of mandatory federal insurance for RISDIC-insured institutions. His motion to hold such hearings failed because of a two-to-two vote. (Begin and Senator Albert Russo voted for the hearings, Representative Joseph Cassinelli and DBR Director Clifton Moore opposed them, and Attorney General Violet was absent.) Although Begin voted in support of BBI hearings and applauded Governor DiPrete's leadership on the issue of federal insurance for RISDIC members, he later told the Providence Journal that "he does not necessarily support the Administration's position" that federal deposit insurance be required. He maintained that the issue was complicated and should have a "thorough review by the bank board".[131] The Commission

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[131] Providence Journal, April 17, 1986.

is surprised that he did not follow through with his stated position. As Treasurer, Roger Begin did not testify in support of the Gaschen bill.

The Commission is also surprised that both Treasurer Begin and his successor, Anthony Solomon, deposited substantial amounts of State funds in RISDIC-insured institutions despite their on-and-off concerns about RISDIC and some of its members.[132] Both of them informed the Commission that they did not receive copies of the Stitt-Black report, nor did they request copies of DBR examinations of RISDIC or any of its members.

[132]General Treasurer Solomon drafted a bill in 1990 which would have required any public depository institution taking deposits of state funds. This bill would have protected state funds in the event of a loss at one of the institutions holding state funds. The proposed bill was never enacted; instead the Assembly adopted a joint resolution creating a commission to study the issue of collaboralization. Joint Res. 90-259. General Treasurer's proposed bill and the joint resolution are included as Appendix 14.

C. ADMINISTRATIVE BRANCH

1. The Board of Bank Incorporation

The Board of Bank Incorporation (BBI) consists of the Director of the Department of Business Regulation, the Attorney General, the General Treasurer, one member of the House of Representatives, and one member of the Senate. The five-member BBI is statutorily empowered to approve the establishment of banks and other financial institutions, to review proposed amendments to bank charters, to approve the creation or relocation of bank branches, and to exercise various other regulatory functions.[133] The assemblage of such a powerful group of state officials and the very title of the agency conveyed a false sense of security to the public. The public perception is that the BBI is a regulator of the regulators.[134]

Unfortunately, despite its limited regulatory mission of BBI, the statutes confer upon it no role in the examination of institutions. BBI is without independent staff support, and it relies generally on DBR for staff work regarding pending applications for new charters and new branches. Even though BBI lacks the tools to perform serious regulatory functions, it has the authority to hold hearings on the fiscal well being of the state's financial institutions.

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133 R.I. Gen. L. sec. 19-1-3.

134 "Quis Custodiet ipsos custodes?" ("who will guard the guards themselves?") was asked as far back as in the first century A.D. by Juvenal in his Satire VI.

While BBI did not have automatic access to the periodic examinations conducted by DBR, it apparently could have sought access to such information. The relevant statute permits DBR to disclose its findings to "such other officers of the state as may have occasion and authority to inspect in the performance of their duties."[135]

BBI could have played a more assertive and inquisitive role in its chartering of branches and banks. It could have investigated the financial health of the applicant institutions and directed DBR to further examinations. Evidence of this was presented in 1986 when the Attorney General challenged the application of Rhode Island Central Credit Union for a new branch. In her written dissent, she questioned the "unsafe practices" at Rhode Island Central and appropriately queried about the dramatic thirty percent increase in the institution's deposits over the first six months of 1986.[136]

Such challenges, however, were the exception and not the norm. Under the circumstances, BBI did not play a major role in safeguarding the rights of the depositors. It relied on DBR to do the job. There is almost a unanimity among the individuals that the Commission interviewed, that as presently constituted, BBI is there to legitimize rather than to regulate Rhode Island's financial institutions. It either should be strengthened or abolished. One thing is certain, for the public's sake, it should not be portrayed as a strong oversight body guarding the financial stability for the State of Rhode Island.

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[135] R.I. Gen. L. Sec. 19-21-38.3

[136] Board of Bank Incorporation In Re: Application of Rhode Island Central Credit Union for a Branch Office at East Greenwich, Rhode Island, dated November 18,1986 (Attorney General Arlene Violet dissent)

2. Department of Business Regulation (DBR)

The Department of Business Regulation (DBR) oversees the state's financial institutions through its banking division, headed by an associate director (also referred to as the superintendent of banking). DBR has several additional divisions, including one for insurance. The director of DBR is appointed by the governor. There have been six DBR directors since 1983, most of whom lacked direct banking or audit experience. The position of associate director was held by Susan Hayes from 1986 through 1990. She was formerly the chief legal counsel to DBR, and also did not have a banking or audit background.

The high turnover rate among the directors, and their lack of any prior experience within DBR, made it impossible for any one to know fully the history of their problems and the range of their authority, to determine appropriate actions, or to see those actions through. Robert Janes, the DBR director from 1989 through mid-1990, and Nancy Mayer, DBR's chief legal counsel since 1986, were unfamiliar with 1986 legislation that empowered the director of DBR to require federal insurance for institutions deemed to be engaged in unsafe practices.[137]

Several DBR directors, and other top DBR officials, had a strained relationship with RISDIC's president, Peter Nevola. Tensions surfaced when Director Thomas Calderone expressed serious concerns to the RISDIC board about six "problem institutions" in 1982. Calderone also challenged RISDIC's authority to insure out-of-state institutions, taking the issue to the Rhode Island Supreme Court. The mistrust worsened as Director

[137] R.I. Gen. L. Sec. 19-11-9.1; Janes tr., p. 20 and Mayer tr., p. 43.

Clifton Moore insisted in 1985 that Peter Nevola "report every afternoon at four o'clock what his reserves were at RISDIC."[138] Other DBR employees interviewed by the Commission confirmed that there was a "turf war" between DBR and RISDIC, with RISDIC "always trying to fend us off."[139] These strains undoubtedly lessened the flow of information and cooperation between DBR and RISDIC, and hampered the effectiveness of the dual regulatory system.

DBR's bank examination staff was and is inadequate for the tasks required by state law. There are approximately the same number of examiners (12) now as there were 35 years ago, according to a long-term employe who supervises examinations at DBR.[140] During that time the number of institutions for which DBR's banking division is responsible has increased substantially. So has the size of these institutions and the complexity of the regulations. As a result, DBR's schedule of examinations, intended by legislation to be performed annually, slipped to an informally accepted 18-month schedule by the late 1980's. DBR also started relying whenever possible on the work of RISDIC examiners or CPAs as a substitute for its own examiners.

DBR was subject to the same budget cuts and position freezes that other state departments experienced, and DBR met with mixed success in eliciting new resources. Since DBR charged a fee to those institutions it examined and in so doing recovered the cost of its examination staff[141]

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[138] Moore tr., p. 4.

[139] Mayer tr., p. 40.

[140] Paolantonio tr., p. 5-6.

[141] Letter from DBR Director Clifton A. Moore to Governor Edward DiPrete, March 11, 1985

the function was self-supporting. Increasing the number of examiners to work in the field should have been an "easy sell" at budget time. It was reasonable for DBR to expect that the work program for an examination conducted by RISDIC would be on a par with that of DBR. DBR's examination supervisor knew and trusted RISDIC's president and two vice presidents from the years they had worked with him as DBR bank examiners.[142] Sometimes DBR and RISDIC staff members were scheduled to work together on examinations. DBR examiners also believed that RISDIC shared DBR's regulatory outlook on its member institutions,[143] although they did not consider RISDIC examiners to be as well-qualified or thorough as they were.[144] As the problems at Heritage unfolded in 1990, it became clear that DBR overestimated RISDIC's interest in regulating, as opposed to promoting, its members.

DBR's examination process results in substantial reports which outlined financial information about the institution and the details of any findings, along with the examiners' recommendations concerning actions management should take to correct any problems. Reports are written by the staff member in charge of the examination, and are reviewed by the supervisor of examinations and the associate director of the banking division before being issued to the examined institution's management, board, and insurer. Upper-level DBR managers are responsible for assessing whether conditions call for additional action (such as special supplementary communications directing specific actions, issuing "cease

142 Paoloantonio tr., p. 9.

143 Pare tr., p. 6.

144 Ibid., p. 32-33.

and desist" orders, recommending federal insurance, or putting the institution into receivership). Otherwise, DBR simply reviews management's response to examination reports to ascertain if and how management plans to correct any problems.

Unfortunately, warning flags sometimes went unnoticed in the press of issuing reports. For instance, the alarming rate of loan delinquency noted in Heritage's 1987 examination report (18.1%) did not prompt the associate director or the examination superintendent to take extra action. Neither remembered seeing that figure in their review, and both stated that it should have prompted them to take extra steps at the time of issuing the report.[145]

DBR had no formal mechanism or procedures for assessing audit risk and ensuring that the schedule for examinations provided adequate audit coverage of RISDIC members. Informally, DBR's supervisor of examinations and RISDIC's vice president for examinations coordinated their schedules and shared examination results. Formally, there was always an exchange of final reports.

Although it was desirable for DBR to follow up on the resolution of examination findings within six months, this was a practical impossibility. In general, the resolution of problems depended on the good faith of an institution's management to follow through on the corrective action plans communicated to DBR.

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145 Hayes tr., p. 14; and Paolantonio tr., p. 38.

SECTION III: RISDIC'S DOWNFALL (1981-1990)

After its membership peaked in 1980, RISDIC began its decade of decline. In September, 1981, there was a bitter fight for control of RISDIC. The fight was over the issue of whether RICUL and its President Robert Bianchini was supported by and working with Joseph Bellucci. Bianchini was opposed by RISDIC President, William Favicchio, who was also opposed to the interlocking common directorates between RICUL and RISDIC. In the battle for control, when the Favicchio group (which included George Barnes, Executive Vice President of RISDIC from February 1978 to October 1981) solicited support from member institutions, they were told that the members had been called by Peter Nevola, then Banking Superintendent, and urged to vote for Bellucci, not Favicchio.[146] Mr. Favicchio was forced out as RISDIC's president and replaced temporarily by Bellucci, who remained Chairman of the Board after Peter Nevola was hired as the new president. The dispute spawned a lawsuit by Mr. Favicchio, who levied serious charges concerning mismanagement and conflicts of interest at RISDIC.[147]

RISDIC also lost its reinsurance in 1981 when Aetna got out of business of reinsuring deposits. RISDIC carried only $5 million in reinsurance, but the loss was considered significant by RISDIC's outside

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[146] RISDIC Board minutes, September 15, 1981, and Favicchio memorandum dated September 15, 1981.

[147] Favicchio was particularly concerned about the cozy relationship between RISDIC and RICUL-CCU, particularly the fact that Robert Bianchini of RICUL often attended RISDIC board meetings. See memorandum from Favicchio to RISDIC Board attached to RISDIC board minutes, September 15, 1981, in Appendix 17.

auditors, Peat, Marwick & Co. The auditors issued a "qualified" opinion in 1981. They were replaced the following year.

RISDIC's membership started eroding as credit unions nationwide were increasingly favoring federal insurance. RISDIC lost six members in 1982, and five more in 1983. There were specific reasons why Rhode Island credit unions might have wanted to leave RISDIC. Quite bluntly, there were serious problems at some member-institutions. The president of East Providence Credit Union had recently been removed for embezzlement.[148] In November 1982, six institutions were identified by DBR Director Thomas Calderone as "problems that should be dealt with expeditiously" -- Marquette, Co-Op, Acacia, East Providence, Scituate, and Greenwood. Calderone expressed his concerns at a RISDIC Board meeting, where he also questioned whether some RISDIC institutions were involved in "fraudulent loan applications."[149] RISDIC immediately hired Duffy & Shanley, Inc., the firm that later produced the "Carved in Stone" ads, to draft a "reserve letter to be used if public relations is necessary." [150] The need arose quickly. RISDIC was notified in early 1983 that the State Police were investigating two of the six "problem" institutions: Scituate and Greenwood.[151]

RISDIC's relationship with DBR grew worse. Director Calderone issued a cease-and-desist order in connection with RISDIC's insurance of a commercial bank in Minnesota. RISDIC ignored the order and sought to

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148 RISDIC Board Minutes, November 24, 1981.

149 RISDIC Board Minutes, November 3, 1982.

150 RISDIC Board Minutes November 9, 1982.

151 RISDIC Board Minutes, January 11, 1983, p.3

have Calderone disqualified for "lack of objectivity." [152] DBR sought a preliminary injunction in court. The next two DBR directors, Carroll and Moore, saw the litigation through an appeal to the Rhode Island Supreme Court. Although RISDIC prevailed on the interpretation of its Charter, Director Moore exercised his authority to prohibit insuring out-of-state members on different grounds--by declaring it an "unsafe practice." That same year, in 1985, DBR sued Marquette for "excess exam changes." Because RISDIC had literally been running Marquette, RISDIC defended the suit.[153] These disputes were only a few of the problems RISDIC faced in 1985, a critical year in RISDIC's downfall, and a year when several warning signals were sounded.

A. EARLY WARNING SIGNALS

1. Warnings from Ohio and Maryland

Private deposit-insurance funds failed in Maryland and Ohio in 1985. Private deposit-insurance schemes came under scrutiny around the country. An article in the Wall Street Journal detailed the status of private insurance funds around the country.[154] The Banking Committee of the U.S. Senate considered the issue during hearings on deposit insurance reform in the summer or 1985[155]. Several private funds were subsequently phased

[152] RISDIC Executive Committee Minutes, December 7, 1983.

[153] RISDIC Minutes, April 9, 1985.

[154] Wall Street Journal, May 16, 1985.

[155] "Deposit Insurance Reform and Related Supervisory Issues" Hearings before Senate Committee on Banking, Housing, and Urban Affairs: July 23, 25, 31, and September 10, 11, 1985.

out, including thrift funds in North Carolina and Massachusetts, and credit union funds in Wisconsin and Utah.[156] These funds insured thrift institutions, not credit unions, as RISDIC's supporters pointed out on various occasions. But that does not differentiate them from RISDIC, many of whose members were either chartered as loan and investment companies or simply acted like them.

The failure of the Maryland Savings Share Insurance Corporation bore many similarities to the problems with RISDIC. Among the causes of the Maryland collapse, according to a subsequent investigation by Special Counsel, were:

> (1) mismanagement by state regulators and fund administrators who "had knowledge of insider dealing, mismanagement, violations of laws and regulations, and other unsafe and unsound practices but failed to take appropriate action pursuant to their authority to correct or sanction those practices."
>
> (2) gross mismanagement of "aggressive, rapidly expanding" institutions which engaged in "deceptive accounting practices" and violated laws pertaining to insider dealing.
>
> (3) self-regulation gone awry because the Board of Directors of the fund "acted primarily to promote the industry, instead of acting to safeguard depositors' funds."
>
> (4) "the General Assembly missed opportunities to strengthen regulatory powers but was receptive to efforts to expand the investment authority of savings and loans associations." [157]

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156 "Share Insurance: Reacting to Public Perception," Credit Union Magazine, July 1985: pp.38-40

157 See Report of the Special Counsel on the Savings and Loan Crisis, State of Maryland, Executive Summary, p. 1-2.

The warnings from Ohio were much the same. A Select Committee of the Ohio General Assembly appointed to redress weaknesses in the Ohio Division of Banks made fifty-six recommendations for legislative action. These included recommendations for increasing regulatory expenditures, strengthening enforcement powers, and bolstering the requirements for outside audits.[158]

RISDIC monitored these events closely. The crises in Maryland and Ohio were discussed at a Special Board of Directors meeting on April 29, 1985, where Mr. Maggiacomo of Greater Providence Trust Corporation was hired part-time by RISDIC "to utilize his expertise principally in the field of legislation and regulation." The request originated from Congressman St. Germain.[159] RISDIC proceeded to work with the national trade association to draft standards for private insurers, and RISDIC eluded to this effort in its television ads.

2. Specific Warnings about RISDIC: The Stitt and Benoit Reports

Another warning was sounded in September 1985 when the Providence Journal reported the "serious financial condition" of a large Rhode Island loan and investment company. This prompted Attorney General Violet to conduct an inquiry, which resulted in the now-famous Stitt Report.[160] Authored by Special Assistant Attorney General Robert S.

158 See Protecting the Depositor. Report and Recommendations of the Joint Select Committee on Savings and Loans, 116th Ohio General Assembly, February 1, 1986, pp. 30-42.

159 Minutes, Special Board of Directors' meeting, April 29, 1985.

160 Stitt Report, p. 15

Stitt and Investigator Charles O. Black, the report painted a dire picture of RISDIC and its members. The picture was so bleak that the authors, fearing a self-fulfilling prophecy, treated it as highly confidential. The contents were not made public until after RISDIC failed on December 31, 1990. Governor DiPrete received the report on December 16, 1985.

The Stitt Report indicated that three major RISDIC members -- Marquette and East Providence Credit Unions, and the Greater Providence Deposit Corporation -- were in "serious financial condition." High loan delinquency rates were reported at all three. Their portfolios were described as "replete with out-of-state second (equity) mortgages and other high risk paper." "Unduly concentrated loans to offices and directors" were detailed at Marquette, Greater Providence, and Heritage. The report indicated that the "sound surplus" at East Providence and Marquette (.5 and .8% respectively) was well below the statutory requirement of 5 percent.

The Stitt Report also described "rampant and unorthodox accounting/management practices" involving capital certificates, and "irregular and superficial audits." The Report detailed the concerns voiced by Peat, Marwick, before being replaced as RISDIC's auditors, about the adequacy of RISDIC's reserves. It concluded that RISDIC was "archaic and dangerous," and should be replaced by federal insurance.

Stitt was not the first public official to sound warnings about RISDIC. Indeed, the Stitt Report cites several concerns raised a year earlier by U.S. Attorney Lincoln Almond. Almond thought that RISDIC was "a house of cards" and he concluded that "there was absolutely no need for the State of Rhode Island to sanction private insurance [and] that it was a foolhardy and substantial risk for the State treasury." Almond conveyed his concerns

to Attorney General Violet, Governor DiPrete, and the Department of Business Regulation. "I would not discuss my concerns publicly," however, Almond noted.[161] The U.S. Attorney's Office had no jurisdiction over state-regulated lending institutions. Besides, Almond added, "the problem if you went public with your extreme criticism [was that] you could very well cause the problem, which would be a run and a collapse. It was a Catch-22 situation."

Governor DiPrete turned the Stitt Report over to Frederick Lippitt, Director of the Department of Administration. Lippitt enlisted Normand Benoit as special counsel to take an independent look at the issue. This was understandable; the Stitt Report had a slightly hysterical tone, and the charges it leveled were extremely serious. But Benoit reached very similar conclusions. By memo of February 20, 1986, he warned that "major losses in any one of a number of RISDIC insured institutions could wipe out the fund." Highlighting the most critical insurance concepts, Benoit correctly pointed out that:

> "With FDIC and FSLIC, the size of the fund in relation to any one insured institution is quite substantial, and neither fund should be wiped out by any institution having a major problem. The same cannot necessarily be said with confidence about RISDIC. Moreover, those funds have national diversity so the ability to assess members for additional reserves is real. With RISDIC's base primarily limited to Rhode Island, the ability to impose additional assessments on members institutions is ephemeral."

[161] Boston Sunday Globe, January 6, 1991.

The Benoit memo also pointed out (presciently) that some RISDIC members did not have sufficient liquidity to withstand a run. The memo recommended that:

> • The State should be prepared to commit the resources to enforce annual bank examinations by the Department of Business Regulation, except for federally insured entities.
>
> • The Administration may have to form a policy in the immediate future on whether Rhode Island financial institutions should be required to have Federal Deposit Insurance.
>
> • The Executive Branch should have in place potential emergency proclamations and documentation...which can be employed on a quick basis.
>
> • Declaration of bank holidays should be avoided if at all possible.

Director Lippitt sent Governor DiPrete a memorandum the next day, indicating several actions taken by DBR Director Moore to strengthen DBR's oversight of RISDIC. This impressive list included:

> (1) directing all RISDIC institutions to establish with the Federal Reserve Bank of Boston the necessary documentation to allow them to draw on the liquidity facility of the Federal Reserve.
>
> (2) requiring monitoring statements "on a more frequent basis" than monthly, "including daily, if appropriate."
>
> (3) asking RISDIC for "detailed information on the cost of reinsurance, its availability, and for the documentation of the steps that RISDIC has taken to date to obtain such reinsurance."

The memo left two policy matters for Director Lippitt to discuss with Governor DiPrete. The first issue was whether the state should require

RISDIC-insured institutions to obtain federal insurance. Lippitt summed up the basic pros and cons: "This would clearly provide greater security to their depositors. It could very well, however, force some RISDIC member institutions out of business since they might not be able to qualify." The question whether to take on mandatory federal insurance would have to be answered by the time the House Finance Committee held hearings on the issue three months later. The second policy matter in Lippitt's memo was what to do in case of an emergency: "should state funds be appropriated to guarantee any shortfall"? This question did not demand an answer until the crisis that occurred on December 31, 1990.

3. The Great Non-Debate: The Gaschen Bill (1986)

In 1986, Senator John D'Amico and Representative Francis Gaschen introduced legislation that would have required all deposit-taking institutions to obtain federal insurance. These bills ultimately failed. The bills coincided with Attorney General Violet's concerns about RISDIC.

In a February 23, 1986 article in the Providence Sunday Journal, Violet expressed her concern that RISDIC was a loosely regulated private insurance system, similar to the one that collapsed in Maryland, although she was "not saying RISDIC specifically has a problem."[162] She did, however, express concerns about the viability of self-monitoring. This article also revealed the existence of Violet's report to Governor DiPrete on RISDIC. A spokesman for the governor acknowledged the existence of the

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[162] J. Brogan, "RISDIC: Does it adequately protect depositors?," Providence Sunday Journal, February 23, 1986. The article is reproduced as Appendix 18.

report and assured that the administration was "on top of the situation." RISDIC's president, Peter Nevola, expressed surprise at the introduction of bills to require federal insurance.

Attorney General Violet initially stopped short of public endorsement of the bill, suggesting instead a thorough examination of the issue. Representative Robert V. Bianchini, vice chairman of the Finance Committee of the House of Representatives, took up the attorney general's challenge. In his capacity as president of Rhode Island Credit Union Affiliates (Rhode Island Credit Union League, RICUL Corporate Credit Unions, and RICUL Services, Ltd.), Bianchini on February 26, 1986, wrote a lengthy letter to Violet, arguing, among other things, that:

> • In simple terms . . . there is more than a billion dollars in credit union assets in Rhode Island which emphatically states: no one single credit union can be permitted to fail. . . . It is not a matter of contractual obligation through state or federal insurance programs, but rather, a matter of our cooperative heritage which dictates that philosophy. . . .
>
> • There is no comparison [of] the operating environment and management of insurance funds in Maryland and Ohio to that of Rhode Island. Unlike the Maryland and Ohio situations, RISDIC membership is not comprised of savings and loan associations. . . .
>
> • There are healthy, very strong credit unions successfully operating in our state today, only because of the fact they were insured by RISDIC. . . RISDIC's careful and personal attention to their special needs resulted in a complete restoration of their financial viability. . . .
>
> • Every credit union operating in Rhode Island is permitted to apply for a line of credit with RICUL Corporate Credit Union, our state's credit union liquidity facility. RICUL Corporate presently has assets exceeding $152 million. More importantly, RICUL is a member of the U.S. Central Credit Union, a $12 billion credit union central banking facility in which all of the states' corporates, such as RICUL Corporate, invest their surplus funds and are granted corporate lines of credit.[163]

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[163] Bianchini's letter to Violet of February 26, 1986, is reproduced as Appendix 19.

The DiPrete Administration ultimately endorsed bills requiring federal insurance for all financial institutions.[164] Governor DiPrete wrote to Violet and her fellow Board of Bank Incorporation (BBI) members encouraging them to support the federal insurance bill. Violet agreed and urged the governor and other BBI members to testify at hearings on the bill.

A hearing on Representative Gaschen's bill occurred before the House Finance Committee on May 12, 1986. Violet and her special assistant, Robert Stitt, testified in support of the bill. Instead of appearing personally at the hearing, Governor DiPrete sent his special counsel, Normand Benoit.

Gaschen introduced the bill at the request of Stan Moskwa and Robert Bergeron, both of whom were involved in credit unions that had been members of RISDIC.[165] Usually the sponsor of a bill requests a hearing date on the legislation he or she proposes. In this case, Representative Bianchini, an opponent of the bill, requested the hearing.[166]

At the five-hour hearing before the House Finance Committee, Gaschen testified that his bill was preventive in nature and that he knew of no immediate problems at RISDIC. He argued on behalf of prudence, in order to avert a possible fiscal crisis similar to those experienced in Ohio, Maryland, Nebraska, and various other states. Gaschen's testimony elicited

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164 At the urging of special counsel, Normand Benoit, the DiPrete administration introduced a package of legislation in 1986 that would have restricted financial institutions' activities and strengthened state regulators' powers. Although portions of the package passed (e.g., R.I. Gen. L. sec. 19-20-28, and sec. 12-21-44), other recommendations were rejected by the General Assembly.

165 Gaschen tr., p. 4.

166 Ibid., p. 6.

harsh questioning and hostile reaction. Representative Donald J. Ferry, asked why Gaschen wanted "to take an organization with absolutely no problems, that does a credible job and put them out of business?"[167]

Attorney General Violet offered to present a copy of the confidential Stitt-Black report, but only in executive session. Special Assistant Attorney General Stitt commented on the failure of thrifts in other jurisdictions and the general inadequacy of private insurers to fulfill their function. Opponents of the bill repeatedly pointed out that the failures in other jurisdictions were of savings and loan institutions, not credit unions. This argument obscured the fact that RISDIC's largest members were credit unions in name only, virtually operating as banks, and that eight others were chartered as loan and investment companies.

Representative Bianchini coordinated the defense of RISDIC. Prior to the May hearing of the Finance Committee two lobbying dinners were held in the Aurora Club for selected members of the Committee. Peter Nevola attended. Representative Joseph Casinelli, chairman of the House Corporations Committee and a member of the Board of Bank Incorporation, attended one of the dinnner and served as a strategist and subsequently testified against the Gaschen bill.

Peter Nevola came well prepared for the hearings. He had access to the confidential so-called Violet report, at least "pieces of it," "pieces that talked about some specific member institutions" [Greater Providence, East Providence].[168] Armed with experts, charts, and comparative figures,

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[167] The Commission is grateful to both Speaker DeAngelis and Rep. Bianchini for providing the video tape of the Finance Committee proceedings.

[168] Mr. Nevola does not recall how he obtained the report. "It came to my desk in a manila envelope with no return address. Excerpts from this report." (Nevola tr., p. 25.)

Nevola dominated the meeting. The committee was assured that RISDIC's system of monitoring and supervising its members was a national model of competence and efficiency. RISDIC's reserves were touted as superior to the federal alternatives, and RISDIC was held out as more flexible and helpful to its members.

The House Finance Commitee adjourned without voting on the Gaschen bill or considering the attorney general's offer to produce her report. Within days of the hearing, committee members met with Speaker of the House Matthew Smith to discuss the bill.[169] The committee took no further action. The reason, according to former Speaker Smith, was that the committee did not feel there was sufficient evidence after the hearing to "vote the bill up."[170] Speaker Smith never sought or obtained a copy of Attorney General Violet's report.[171]

There was also a brief hearing before the Senate Corporations Committee on the parallel bill introduced by Senator D'Amico, but this Commission did not receive tapes of any senate proceedings. Senator John Correia, an officer of the East Providence Credit Union, presided over a hearing that reportedly lasted approximately ten minutes during which he said that there was no concern with the solvency of credit unions.[172] The D'Amico bill did not emerge from the committee.

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169 Morancy tr., p.20, and Smith tr., p. 10.

170 Smith tr., p. 10.

171 Ibid., pp. 12-13.

172 D'Amico tr., p. 3.

Several interviewees have brought to the Commission's attention R.I. Gen. L. sec. 19-11-9.1, a bill that was passed in 1986 as a so-called compromise to the Gaschen bill.[173] They suggested that this legislation empowered DBR to do what the Gaschen bill would have required, and was a responsible approach to the issues raised by Gaschen's bill. In correspondence to this Commission, counsel for incumbent Speaker of the House DeAngelis, states that sec. 19-11-9.1 "empowered the Director of DBR to require, on an individualized as-needed basis, exactly what the so-called 'Gaschen bill' would have required on a generalized, across-the-board basis."[174]

An analysis of the statute does not support the claims made on its behalf. The statute empowers DBR to require any RISDIC member to switch to another deposit insurer, but only upon a finding that the RISDIC-insured institution "is violating its charter, articles of incorporation or articles of association, or the law, or that it is conducting its business in an unsafe, unauthorized or dishonest manner . . ." The statute requires that RISDIC be given an opportunity to rehabilitate the institution. Only if RISDIC fails to accomplish that task is DBR permitted to order the institution to transfer to another deposit insurer. However, it seems highly unlikely that the affected institution would be a viable candidate for federal insurance. In other words, the statute empowers DBR to mandate federal insurance for institutions least likely to qualify. Moreover, the

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173 e.g. Smith tr., pp. 14-16.

174 February 12, 1991, letter from Edward Fogarty to Thomas M. Dickenson, reproduced as Appendix 20.

statute actually strengthened RISDIC's control over its member institutions and its powers vis-a-vis DBR.

The 1986 statute does not address concerns about the health of RISDIC. DBR was empowered to remove sick institutions from RISDIC, but only when there was no realistic likelihood of finding another insurer for them. In short, the 1986 statute can hardly be characterized as a reasonable response to the issues identified by Senator D'Amico, Representative Gaschen, and Attorney General Violet.

Without foresight, the legislative leadership killed the D'Amico-Gaschen proposals, forestalling consideration of additional information that might have led to amendments to provide for a longer and more orderly transition to federal insurance during relatively positive economic years. The 1986 defeat was so decisive that the bills never emerged in later legislative sessions. RISDIC's protectors in the legislature acted to defend their institutions.

A couple of months after the hearing, Joseph Bellucci, chairman of RISDIC's board of directors, stated ". . . RISDIC remains the nation's model. This was never more evident than in our historic and heroic stand against the ill-advised efforts of a few, but predictable, pockets of discontent in this community. In testimony to the clear, convincing and resounding support RISDIC so deservedly enjoys, it was the detractors, not RISDIC, who went down to defeat."[175]

4. RISDIC's Aggressive Response (1985-1989)

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[175] RISDIC 1986 Annual Report, p. 2.

Although RISDIC prevailed in the General Assembly, defeating proposals for mandatory federal insurance, it still faced serious internal problems. "The year 1985 put great stress on private deposit insurers," according to the 1986 Yearbook of the National Association of Share Insurance Corporations (NASIC). For the first time, NASIC members experienced a drop in total insured deposits; RISDIC was no exception. In the fall of 1985, while the Stitt-Black was being prepared, RISDIC lost seven more members. At year's end, RISDIC suffered its first drop in total deposits. (Appendix 21)

RISDIC's response was swift and, in the short run, effective. The Board of Directors took several actions to counter the loss of member institutions and individual depositors: it authorized accounts over $100,000, began a substantial advertising campaign to boost public confidence, and paid dividends to its members.[176]

These measures built back RISDIC's deposit base, but they did not prevent the additional loss of members. The national trend away from private deposit insurance continued, and RISDIC monitored these events closely. [177] By 1988, RISDIC had only 46 members--less than sixty percent of the membership in 1980.

These developments were warnings in and of themselves. The decline in membership placed an ever greater burden on remaining

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[176] Apparently for outward appearances, RISDIC adopted a policy in 1985 that members "contribute semi-annually an additional 1/48th of 1% until such deposits equal 2% of eligible deposits." But the Board was authorized to waive the additional deposits and did so consistently, offering dividends and rebates instead.

[177] See, for example, discussion of "the situation which transpired in Utah," where federal insurance is now mandatory. RISDIC Board Minutes, June 9, 1987.

members if it ever became necessary to replenish the fund through reassessments. Indeed, one of the proximate causes of RISDIC's collapse was the unwillingness of some members to accept a reassessment on December 31, 1990. The remarkable increase in deposits at a few institutions also should have raised concerns about RISDIC's stability. Rhode Island Central, for example, grew from deposits of $8.6 million in 1978 to $192 million in 1988. In a competitive retail market such rapid growth in deposits generally signals a problem. Some of this growth was due to new branches, but several of those interviewed noted that substantial increases at several institutions raise questions about money laundering and other roguish practices.

B. THE 1990 COLLAPSE

Three precipitous events led to the collapse of RISDIC on December 31, 1990. First, there were multi-million dollar losses at Jefferson Loan and Investment Company depleted RISDIC's reserves. Next came the apparent embezzlement at Heritage Loan and Investment Company, coupled with the mysterious disappearance of its president, Joseph Mollicone. The events at Heritage and Jefferson shook public confidence in RISDIC, leading to the final blow: "runs" on several RISDIC member institutions, including massive and, eventually, unmanageable withdrawals from Rhode Island Central Credit Union. These events are treated below in chronological order.

1. Jefferson Loan and Investment Company. Jefferson's problems date from its creation in 1988. When the license was granted, Jefferson was permitted to begin operation with the minimum start-up capital of $1,000,000, which had been borrowed from Fleet National Bank by Jefferson's parent, Jefferson Financial Group. The $1,000,000 loan to Jefferson Financial Group was put into a Fleet certificate of deposit issued in the name of Jefferson Loan and Investment Company but held at all times by Fleet, an arrangement that was not disclosed to DBR nor discovered by them until much later.

A November 1988 article in the Providence Journal about brokered certificates of deposit that were being offered by Jefferson aroused the interest of Nancy Mayer, Chief Legal Counsel for the Department of Business Regulation.[178] Ms. Mayer spoke first with then-DBR Director Robert Janes, and then convened a meeting with Cerilli regarding the brokered certificates. Mayer inquired about Jefferson's portfolio and learned that, in addition to its real estate loans, Jefferson had a small portfolio of equipment leases[179]. Asked about the residual value of the leases and the nature of Jefferson's ownership claim on them, Cerilli did not appear knowledgeable to Mayer.[180] This concerned her, and she began to investigate Jefferson further.

During the course of this inquiry, Mayer discovered that Jefferson was offering above-market interest rates.[181] This raised some concerns

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[178] Mayer tr., p. 10.

[179] Mayer tr., p. 10.

[180] Mayer tr., p. 11.

[181] Mayer tr., p. 11.

that Jefferson, in order to achieve a profitable spread, was engaging in unduly risky investments. In addition, Mayer became concerned that Jefferson was being used "as a personal piggy bank". She also discovered that Jefferson was buying second mortgages from Homeowners Funding, a company controlled by Peter Salvatore, Cerilli's fellow stockholder in Jefferson.[182] Mayer asked Salvatore about the nature of these mortgages. He assured her that they were written to "Fannie Mae" standards and that he had already packaged some of the mortgages and sold them to some other local banks. Mayer investigated this further by contacting the Chief Executive Officer of one of the banks identified by Salvatore. According to that Chief Executive Officer, his bank rejected Salvatore's offer because the mortgages he offered did not have the proper documentation.[183]

Troubled by what she had learned about Jefferson, Mayer met with Walter Gorman, Deputy Attorney General for Litigation. Describing her view that there was "an utterly unsavory situation" at Jefferson, with possible criminal activity involved, she was told that the Department of the Attorney General was understaffed, with little expertise in white collar crime, and a pressing need to prioritize investigations.[184]

Ms. Mayer also met frequently with RISDIC President Peter Nevola, meetings which were not amicable. Mayer found Nevola "very defensive about the situation."[185] He told her that he had been present during discussions with Cerilli about equipment leases purchased by Jefferson,

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182 Mayer tr., p. 11.

183 Mayer tr., p. 20.

184 Mayer tr., p. 12-13.

185 Mayer tr., p. 14.

and that "he, Pete Nevola, the insurer, had given Jefferson the go-ahead to buy these leases." Nancy Mayer noted that was a "highly unusual activity for the insurer to take."[186]

Mayer was also concerned about the encumbered status of Jefferson's $1,000,000 in capital. She was convinced that the capital was borrowed and therefore in violation of the banking laws.[187] She also learned that Jefferson was "upstreaming" interest payments of $10,000 per month to its holding company. These payments had been characterized as a "management fee." DBR Director Janes issued a Cease and Desist Order to Jefferson, requiring it to stop paying managment fees to its holding company and to discontinue its guarantee of the holding company's note with Fleet. Attorney Mayer expressed concerns to DBR's banking division, but found little interest in the issue.[188]

Edward D. Pare, Jr., currently the Acting Superintendent of Banking, had prior contact with Cerilli from Cerilli's involvement in another credit union.[189] Pare was in the Banking Division at the time of Jefferson's creation, and he had the view that Cerilli was not "the best person to be in banking."[190] Pare personally participated in an examination at Jefferson in March 1989.[191] DBR examiners were reviewing equipment leases from

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186 Mayer tr., p. 14.

187 R.I. Gen. L. sec. 19-20-2.

188 Mayer tr., p. 15.

189 Pare tr., p.11.

190 Pare tr., p.11.

191 Pare tr., p. 12.

Financial Equity Services, Inc. (FES) and Commercial Management Services, Inc. (CMS). Review of the lease documentation revealed that Jefferson had not purchased the leases themselves, but only the cash flow from the leases.[192] DBR's examiners questioned the validity of such an arrangement and its possible violation of state banking regulations.

RISDIC President Peter Nevola had stated that he was aware of the concerns at DBR about the high concentration of Jefferson's assets in the CMS/FES equipment leases. According to Nevola, Jefferson agreed to reduce its concentration, but the day after making the agreement, both CMS and FES filed Chapter XI bankruptcy proceedings.[193] Soon thereafter, Nevola spoke with Cerilli and told him that Jefferson could no longer book the income from those leases.[194] The write-down of those leases exhausted Jefferson's capital. RISDIC took control of Jefferson in February 1990. RISDIC's 1989 audit report indicates that as of December 1989, RISDIC had set aside $3,900,000 in connection with Jefferson.

On February 12, 1990, Director Janes issued an Order to RISDIC concerning Jefferson. Finding that Jefferson was engaged in "unsafe and unsound practices, insolvency, improper activities violative of [statute], lack of effective Bank Board control, and ineffective managment," Janes ordered RISDIC to "take such remedial action as may be appropriate under its rules and regulations to protect the Rhode Island Share and Deposit Indemnity Corporation (RISDIC) and the interests of the depositors of the Jefferson Loan & Investment Bank", pursuant to R.I. Gen. L. sec. 19-11-9.1.

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192 Pare tr., p. 14.

193 In re Commercial Management Services, No. 89-10618-JNG (U.S. Bkr. Ma.) Nevola tr., p.18.

194 Ibid, p.21.

The Order required RISDIC to take appropriate remedial action on or before February 26, 1990.

In a March 5, 1990, letter from Director Janes to the RISDIC Board of Directors, Janes outlined his concerns for the manner in which RISDIC had reacted to his February 12, 1990 order. Because this letter aptly illustrates the tense relationship between DBR and RISDIC regarding the Jefferson affair, the entire text of the letter is set out below:

Board of Directors
Rhode Island Share and Deposit Indemnity Corp.
1220 Pontiac Avenue
Cranston, RI

Dear Members of the Board:

It is my understanding that the Board of Directors has called for a special meeting of the Board in order to discuss the recent assumption of control by RISDIC of Jefferson Loan and Investment Bank.

Although I would like to commend the Board for acting so quickly to take vigorous action once the Department issued its Order of February 12, 1990, I must express my surprise that the Superintendent of Banking and other members of my staff were to be barred from attending the special meeting of the Board scheduled for today.

As you are aware, the Department has had grave concerns about the viability of Jefferson Loan and Investment Bank since approximately February, 1989. We have kept open lines of communication with RISDIC regarding those concerns since that time. Unfortunately, our concerns were well-founded: the original note capitalizing Jefferson Loan and Investment Bank was not in compliance with the law and RISDIC was forced to guarantee the note; furthermore, the $4.5 million dollar lease investments by Jefferson now appear to be worth approximately $1 million dollars, according to the fourth report to the trustee in bankruptcy for CMS and FES.

In light of the fact that the Department's staff showed both foresight and savvy in predicting Jefferson's ill health, we question why RISDIC has

now departed from its prior practice of permitting the Department's staff from attending Board meetings.

Now that RISDIC has assumed control of Jefferson, we would welcome the opportunity to continue to assist the Board in any way that our expertice can be utilized. Naturally, we do not wish to assume the role of making any business judgments; however, we do feel that the Department should continue to work closely with RISDIC and we would have appreciated the opportunity to be present at today's meeting.

Please continue to keep the lines of communication open with the Department. We wish to work closely with you to ensure that our banking community remains healthy and retains the public's confidence.

Very truly yours,

Robert J. Janes
Director

Roughly coincidental with RISDIC's assumption of control at Jefferson, the General Assembly considered an amendment to RISDIC's charter. The bill introduced by Representative Joseph Casinelli, would have permitted RISDIC to set up a "specially organized financial institution" for purposes of transferring the asssets of a member institution. RISDIC would apparently have the authority to operate the new institution for an unlimited period of time. The initial establishment would require DBR approval, but any approvals by the Board of Bank Incorporation would be confidential. The bill was reported out of the House Corporations Committee on June 19, 1990, and passed the House on June 21, 1991. The bill was defeated in the Senate on July 3, 1990.[195]

Jefferson's $1,000,000 certificate of deposit was purchased from Fleet by Marquette Credit Union and, according to Attorney Mayer, RISDIC

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[195] A copy of Representative Casinelli's proposed bill is set out in Appendix 15.

agreed to indemnify Marquette for the underlying note.[196] RISDIC ultimately took the note over from Marquette; the note is still on RISDIC's books, significantly written down. On July 9, 1990, Jefferson ceased operations after RISDIC sold some of its assets and deposit liabilities to a new group, Banner Loan and Investment Bank.

2. Heritage Loan and Investment Company. Following the considerable loss at Jefferson, RISDIC faced an even worse problem at Heritage Loan and Investment Company. Between October 19, 1990, and November 16, 1990, RISDIC poured $17,450,000 into Heritage. This reduced RISDIC's reserves well below the mandatory one-percent requirement. Member institutions were therefore re-assessed $5.5 million to replenish RISDIC's reserves.[197] These payments to Heritage did not destroy RISDIC, but they significantly weakened it. Public confidence was shaken and several member institutions were distressed about both the re-assessment, the first in RISDIC's history, and about how RISDIC handled the situation at Heritage.[198]

Problems at Heritage were recognized long before 1990. Heritage was last examined by RISDIC examiners in 1983 and by the Department of Business Regulation in 1987. Both examinations reported excessive substandard loans. In particular, the 1983 examination report was followed by a memorandum to Heritage's Board of Directors. According to

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196 Mayer, tr., p. 18.

197 RISDIC Board Minutes, November 16, 1990.

198 RISDIC Special Meeting, November 27, 1990.

the memorandum, dated June 13, 1983, the delinquencies at Heritage were a result of the company's "traditional" method of doing business:

> "Loans have been granted with reliance on old relationships of a personal nature with little effort exerted to effect collection on advances which subsequently became delinquent. A borrower's word and a handshake carried more weight than credit information and financial data in evaluating the worthiness of a loan."

The June 13, 1983, memorandum reported that these issues had been raised with management and that policies had been formulated to reduce delinquencies and to improve documentation and bookkeeping procedures.

Heritage was not examined again until DBR conducted an examination in 1987. The report of the examination was sent to Heritage's Board of Directors, and to RISDIC on February 17, 1988. The report cited numerous violations of law and standard accounting practices. It also reported a "loan delinquency" rate of 18.1 percent. According to one DBR supervisor, this rate should have triggered a cease-and-desist order. DBR assigned a CAMEL rating of 2 3 3 1 1 / 2. The DBR report on Heritage was reviewed by one of RISDIC's vice-presidents, who summarized it in a memorandum to the RISDIC president. The memorandum indicated that "management requested a follow-up exam in mid-1988", although it is not clear whether this comment relates to the management of Heritage or the management of RISDIC.

DBR also requested that the management of Heritage respond to the report. By letter of June 10, 1988, Heritage president Joseph Mollicone, Jr., addressed each of the points in the DBR examination report. In essence, Mr. Mollicone represented that a new computer system would be installed to allow for better monitoring of loan status. Mr. Mollicone reported that,

as a result of the DBR examination, considerable improvements had been made in the area of non-performing loans.

On September 14, 1988, Robin Goulet, RISDIC monitoring analyst, wrote a memorandum to RISDIC vice president Daniel Richer regarding Heritage. Ms. Goulet pointed out that there had been a considerable deterioration in Heritage's capital ratios between the 1983 RISDIC exam and the 1987 DBR examination. Ms. Goulet's memorandum reflected her understanding that Heritage was to be re-examined by DBR during the second quarter of 1988.

Notwithstanding the references to a follow-up on the 1987 DBR report, it appears that no further examination of Heritage occurred until RISDIC examiners visited in July 1990. Mr. Mollicone told DBR in late 1988 or early 1989 that an independent examination was to be performed by Laventhol and Horwath, a certified public accounting firm. Associate Director Hayes stated that Laventhol and Horwath provided an engagement letter in 1989, but that no report from the firm was ever received. By June 1990, Hayes considered it important to conduct an examination of Heritage. She told the Commission about a conversation she had with RISDIC President Peter Nevola, in which she informed him of her concerns about Mr. Mollicone's delinquencies at other institutions that DBR had been examining. Hayes was concerned what these delinquencies might portend for Heritage, and she and Nevola agreed that DBR examiners would visit Heritage in early July to begin an examination. That DBR examination never occurred. Instead, in the first week of July, RISDIC examiner Peter Wald was dispatched to Heritage to begin an examination.

Deputy Director Hayes told the Commission that she was quite upset when she learned that RISDIC examiners were at Heritage, as this deviated

from her express agreement with Mr. Nevola. She indicated that when she spoke to Mr. Nevola, he apologized for the mix-up. Both agreed that since his people were still on-site, there was no sense in pulling them out. An examination of documents made available to this Commission reveals a letter dated June 27, 1990, from Heritage president Mollicone to RISDIC president Nevola. In this letter, Mr. Mollicone requests the "assistance by RISDIC personnel" to assist in the upgrading of the general ledger system at Heritage.

Several witnesses informed the Commission that it was "unusual" for RISDIC to perform an examination of Heritage, because Mr. Mollicone was a member of RISDIC's executive board. It was customary for executive board members' institutions to be examined by DBR, in order to avoid any appearance of a conflict of interest.

A RISDIC examining team arrived at Heritage on July 2, 1990. According to RISDIC examiner Peter Wald, his team quickly recognized that the books at Heritage were in a "chaotic" state.[199] RISDIC examiner Michael Brennan assisted in the July 1990 examination at Heritage. He informed the Commission that Peter Nevola was present at Heritage during the examination on occasion, beginning in mid-July, and with increasing frequency later on.[200] The examiners eventually discovered major discrepancy in the recorded and actual amount of outstanding loans. Wald began to "hound" Mollicone for back up documentation on the loans that were "off book." Mollicone promised to get supporting material for these loans, including signed notes from the borrowers. Ultimately, RISDIC Vice

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199 Wald tr., p.20

200 Brennan tr., p. 16.

President Proto and President Nevola began pushing Mollicone for this loan documentation. Since DBR had the discretion to accept an examination by RISDIC in lieu of its own, at least some of the RISDIC examiners were "standing in the shoes" of DBR when they entered Heritage. Yet, despite their swift recognition of serious documentation problems at Heritage, RISDIC officials delayed notifying DBR for a significant period of time. The precise date that RISDIC contacted DBR regarding Heritage could not be determined by this Commission. Mr. Wald informed his superiors at RISDIC of the problems at Heritage immediately; he expected his superiors to notify DBR.[201] Mr. Nevola recalled informing DBR's superintendent of examinations on August 3, 1990.[202] DBR's superintendent of examinatins denied knowledge of problems before September. [203] Hayes recalled that her first knowledge of problems came in September.[204] In any event, RISDIC's response to the problems at Heritage are detailed in the minutes of RISDIC's board and the transcripts of two special meetings of RISDIC's members. Having discovered a significant number of off-line loans, RISDIC examiners attempted to determine whether the loans were authentic. This research led them to conclude that many were not authentic.

The earliest mention of problems at Heritage in the minutes of the RISDIC Board appears on September 5, 1990. The minutes refer to a request from Heritage "in upgrading their accounting system." The September 11, 1990 minutes refer to the continuing examination at

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201 Wald tr., p. 40.

202 Nevola tr., p. 45.

203 Paolantonio tr., pp.55-56.

204 Hayes tr., pp. 49-51.

Heritage. The minutes of October 9, 1990 state that "Mr. Nevola reported that RISDIC is still on the premises and staff is in the process of reconstructing records of the institution." The minutes of October 18, 1990, report that Joseph Mollicone, Jr., resigned as a director of RISDIC, and had consented to RISDIC's taking control of Heritage. The minutes also refer to a "total breakdown of financial data control" at Heritage. The RISDIC Board authorized President Nevola to transfer $1.6 million to Heritage, to be secured by a capital note. The October 22, 1990 minutes ratify RISDIC's control of Heritage.

In order to make good on the deposits at Heritage, RISDIC infused the institution with $17,450,000 between October 19, 1990, and November 16, 1990. At the same time, in early November, five large RISDIC credit unions withdrew funds from Heritage, on the advice of RISDIC's attorney.[205] These credit unions were all represented on RISDIC's board of directors.[206]

The first reference to "off-line" loans at Heritage appears in the minutes of November 5, 1990. The November 9, 1990, minutes indicated a need to plan for contingencies to avoid a run at Heritage. The November 14 minutes report that DBR had asked Governor DiPrete to close Heritage.

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205 Leco tr., p. 26. See table of credit union withdrawals from Heritage, Appendix 22.

206 Eugene Leco Tr. at 27. General Treasurer Solomon also withdrew state funds from Heritage during this period of time. The General Treasurer explained to this Commission that a state agency was a tenant in a building owned by Heritage President Mollicone. The mortgage holder on that building contacted the treasurer's office, informed the treasurer that Mr. Mollicone's mortgage was delinquent, and asked that the state direct its rent payments directly to the bank that held the mortgage. The general treasurer referred this matter to counsel, who advised that, in light of Mr. Mollicone's delinquent mortgage payments, it might be prudent to withdraw state funds from Mollicone's bank.

The November 16 minutes indicate that DBR had petitioned the court for appointment of a receiver of Heritage.

As a result of RISDIC's massive infusion of cash into Heritage, member institutions were assessed additional contributions to bring RISDIC's reserves up to the required one percent. This assessment weakened the constituent members somewhat and it undoubtedly shook their confidence in RISDIC's managment. RISDIC's treatment of Heritage violated RISDIC's own rules and regulations, not to mention principles of prudence. Heritage had a reputation for high loan delinquency, which RISDIC knew well and had criticized in the past. Nevertheless, habitually late reports were tolerated and annualized examinations fell off diary. The institution was permitted to write excess insurance, inconsistent with RISDIC's own standards for issuing that coverage.

Would early notification of DBR have averted the failure of RISDIC? There is no ready answer to this question, for it would seem that the problems at Heritage were so serious and incurable that nothing could have avoided the crisis that ensued. On the other hand, had they arrived on the scene in July, DBR officials would likely have responded quite differently to the chaotic conditions at Heritage than RISDIC officials did. RISDIC believed that it should offer "assistance" to members in trouble. While laudable in some contexts, this approach seems entirely inappropriate in light of what was discovered at Heritage. DBR officials would likely have exercised their regulatory duties much earlier than RISDIC did.

Public confidence is one of the most important assets of a deposit insurer. When the situation at Heritage came to light, the public undoubtedly became more skeptical of RISDIC and its constituent

members. Withdrawals from some of the larger institutions further weakened their reserves. Recognizing the potential effects of a RISDIC collapse, state officials encouraged RISDIC institutions to apply for federal insurance in order to protect their depositors.

3. The Run at Rhode Island Central

In late November, depositors started withdrawing funds from various RISDIC member institutions. By the end of December, when various proposals for replacing RISDIC were being considered, the situation became chaotic. There were significant withdrawals at many institutions for reasons that remain unclear, but the problem was particularly severe at Rhode Island Central Credit Union. Steady withdrawals exhausted the credit union's cash on hand, and it started tapping lines of credit. As the problem continued, NCUA and RICUL-CCU began monitoring the situation on a daily basis. Withdrawals were in the neighborhood of $500,000 to $2 million per day,[207] and there was one "major" withdrawal.[208] By Friday, December 28, 1990, R.I. Central had used $18.5 million of its line of credit.

There is some confusion about what R.I. Central's line of credit was on December 31, 1990. One interviewee claimed the $39.5 million line was still in effect but that the NCUA simply would not allow RICUL-CCU to lend R.I. Central beyond $20 million.[209] An NCUA representative stated that the mid-November examinations of RISDIC members had renewed NCUA's

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[207] Ruggieri tr., p. 17.

[208] Ruggieri tr., p. 15

[209] Ruggieri tr., p. 14.

concerns about excessive RICUL-CCU lines,[210] and NCUA suggested that RICUL-CCU consider generally reducing all of its outstanding lines of credit. Thereafter, RICUL-CCU "informally" cut R.I. Central's credit line at first to $10 million,[211] which was subsequently raised to an amount which the Commission could not determinee. In fact, both R.I. Central's and other large RISDIC members' lines of credit had become unclear by early December 1990.

As the run on R.I. Central accelerated in the last days of December, daily meetings within RICUL-CCU occurred, concerned with R.I. Central's condition.[212] NCUA representatives participated in the meetings.[213] At the meetings, R.I. Central's net balance on the day's check clearing was examined, and permission was granted for RICUL-CCU to pay the "cash letter," that is, to extend further funds on its credit line to R.I. Central to cover the day's net check clearings.

R.I. Central had pledged a portion of its assets as collateral against the funds already borrowed through RICUL-CCU. Yet, during the weekend of December 29 - 30, RICUL-CCU required R.I. Central to pledge the balance of its entire portfolio of $250 million of assets as collateral for its loans from RICUL-CCU.[214] Since RICUL-CCU then had claims on all R.I. Central assets, it had to have physical access to all R.I. Central loan accounts. That

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210 Baumgardner tr., p. 28.

211 Baumgardner tr., p. 8.

212 Ruggieri tr., pp. 20-21.

213 Ruggieri tr., p.34; Baumgardner tr., pp. 8, 9, 40, stated that while the NCUA made no specific decisions about its credit lines, it did monitor R.I. Central's day-to-day activities at RICUL.

214 Ruggieri tr., p. 35.

weekend, RICUL-CCU physically moved in and took over the R.I. Central's Credit Department, changing locks and paying rent for the space.[215]

On Monday, December 31, 1990, there were so many customers in R.I. Central's Scituate office that extra security personnel were brought in. Almost $7 million was withdrawn that day alone, the bulk of which assumed the form of checks that would have to clear the following Wednesday through RICUL's check-clearing service corporation.

On December 31, RICUL-CCU notified R.I. Central of its refusal to extend any further credit to R.I. Central. One interviewee stated that NCUA told RICUL-CCU that "if they exceeded the $20 million, that they would have all the institutions in Rhode Island that were insured by NCUA pull all their money out of RICUL Corporate."[216] However, the NCUA representative told the Commission that NCUA was only concerned about setting some lending limit to R.I. Central as the run progressed.[217] NCUA was concerned that deposits of federally insured members of RICUL-CCU might be used to fund the run at R.I. Central. It therefore "encouraged" RICUL-CCU's board "to make some decisions relative to what kinds of limits are you setting."[218] Years of NCUA warnings to RICUL-CCU about excessive lines of credit had finally come to roost. With no further credit available for settlement of clearing balances, all the checks written by R.I. Central on December 31 were doomed to go unpaid.

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215 Ruggieri tr., p. 35

216 Ruggieri tr., p. 32

217 Baumgardner tr., p. 9.

218 Baumgardner tr., p. 18.

RICUL-CCU's president aggressively testified during the hearings in 1986 that any credit union could borrow up to 90% of its assets through the Central Liquidity Facility. Yet in 1990 RICUL-CCU could deliver to R.I. Central, in cash, only 10% of R.I. Central's assets while simultaneously freezing R.I. Central's entire portfolio and thereby precluding any other source of funding. Time had come full circle on the man who had proclaimed his ability to deliver liquidity to RISDIC credit unions; ironically, he himself delivered the coup de grace to RISDIC by turning off the liquidity spigot.

4. RISDIC's Final Day

RISDIC's board met on December 31, 1990 to consider a new assessment of members. The minutes show that before any actions were taken, the board had been advised by R.I. Central's president John R. Lanfredi that RICUL-CCU had "terminated his line of credit and R.I. Central credit Union checks issued that day could not be honored." RICUL-CCU would not provide the liquidity R.I. Central had depended on, and there was apparently some resistance from some RISDIC members to raising funds through another assessment. RISDIC could not step in as liquidity provider. R.I. Central was insolvent and RISDIC was helpless to save it.

The RISDIC board then passed a resolution that requested "the immediate appointment of a conservator," its reasons were that "present liquidity demands on some members and . . . on RISDIC cannot be met, [and] . . . the remaining assets of these members are not readily liquid."

When the RISDIC board voted to request a conservator, its members did not believe they were requesting a receiver or the closing down of

RISDIC. The board understood from its attorney that RISDIC would continue in business but with a state-appointed conservator replacing RISDIC's officers and directors temporarily until its problems could be solved.

C. CONCLUSION: WHY DID RISDIC FAIL (OR DID IT)?

This Commission has found that many factors contributed to RISDIC's inability to fulfill its mission as an insurer of deposits. Some of those interviewed for the study have suggested that, notwithstanding its problems, RISDIC did not actually "fail," and that Governor Sundlun should not have acted as if RISDIC's directors had requested a receiver to be appointed. RISDIC's records reveal that the final act of the board of directors, on December 31, 1990, was a vote to request the director of DBR to appoint a conservator, pursuant to R.I. Gen. L. sec. 19-16-1, et seq.

Although some have suggested that RISDIC might have continued doing business while under conservatorship, facts available to this Commission do not support that notion. The minutes of the board of directors meeting on December 31, 1990, reveal that one of RISDIC's largest constituent members, R.I. Central Credit Union, had lost its line of credit as of December 31, 1990. Checks drawn on that institution were about to be dishonored, and it seems highly unlikely that the institution could have opened on January 2, 1991. News of the closure of R.I. Central Credit Union might, in turn, have caused massive runs on other institutions. RISDIC could neither have stopped those runs nor supplied the immediate liquidity necessary to satisfy withdrawal demands. Put in

this context, the distinction between "conservatorship" and "receivership" seems moot.

Whatever term is used to describe RISDIC's final condition, the primary cause of its collapse was the underlying insolvency of some of its member institutions, particularly a handful of those with insured assets many times larger than RISDIC's total assets. Some large and risky loans, made in boom times, were either delinquent, overvalued, inadequately documented to be used as security for the lending institution's own borrowing needs, or a combination of these factors. The lending institutions had failed to make adequate provisions for potential losses on their own books, meaning that insurable losses would eventually land on RISDIC's doorstep.

RISDIC's leaders were overly confident that their monitoring and examination procedures could prevent small problems from growing into insurable losses. Even if practiced strictly as RISDIC defined them, however, these procedures could not have detected an embezzlement scheme on a timely basis. RISDIC's officials were too personally familiar with members to recognize the possibility of a loss arising from management fraud. When the signs of this were discovered at Heritage in 1990, it seemed to take RISDIC completely by surprise, and rocked the insurer's financial base enough to start its collapse.

RISDIC's survival was largely dependent on its members' ability to access lines of credit for liquidity. The local liquidity provider to many of RISDIC's members was the RICUL-CCU, headed by Representative Robert V. Bianchini. One of RISDIC's strongest advocates, Representative Bianchini had provided compelling public assurances that liquidity was not and would not be RISDIC's responsibility if ever its members experienced a

run. However, when Heritage faced liquidity problems in 1990, RISDIC felt it necessary to supply cash to satisfy demands there, or face the loss of public confidence that might follow the closure of Heritage. When push came to shove in late 1990 during a run on R.I. Central Credit Union, RICUL-CCU was unable to provide all of the liquidity it had earlier promised because of lending constraints placed on it by its regulator--the National Credit Union Administration--after reported warnings to RICUL-CCU that its contracted lines of credit were excessive. Thus, liquidity demands of RISDIC members factored into RISDIC's demise.

Contributory or compounding causes of the collapse of RISDIC included structural and operational weaknesses of the General Assembly, the Department of Business Regulation, and RISDIC itself. With friends of RISDIC in key positions in the General Assembly's leadership, legislators were unwilling and unable during the mid-1980's to heed various warning signals. Officers of the executive branch did not communicate information known to them, coordinate their efforts, or exercise their powers in ways that might have mitigated the crisis that eventually occurred.

Collectively and individually, RISDIC staff and directors lacked insurance experience, had little banking experience outside of the small world of Rhode Island state-chartered financial institutions, and possessed modest educational and professional credentials. Nevertheless, they were well compensated and had great confidence in each other's talents and integrity. RISDIC directors seemed generally oblivious to the complex risks for which they were responsible. Examination findings and problems noted at member institutions were filtered out or excused as they were communicated upward within RISDIC. The result was an uninformed board.

RISDIC's carved-in-stone illusion remained intact until RISDIC actually had to fulfill its function as an insurer of a major loss. Once RISDIC was put to this test, its fundamental inadequacies were exposed, and the system rapidly collapsed.