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Regulation, Regulators, and the Crisis of Law and Government

How Governments React to Financial Crises

The Savings and Loan Crisis As a Test Case

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Executive Summary

The Savings and Loan Crisis of the 1980s and early 1990s prompted a multi-faceted response from legislators and regulators, and demonstrated the following points:

- At the most basic level, it is essential that regulatory authority is clear and adequately funded and that personnel are sufficiently trained and independent;

- More broadly, in assessing the government's response to any response to a crisis, it must be borne in mind that a whole host of players are involved, including those in the relevant industry, the media, and the larger public; the regulatory agencies, and even other government actors are only part of the equation;

- While the governing laws are important in shaping the response, extra-legal factors including public perception and political philosophy can be equally important;

- Although regulators are frequently blamed after the fact for having done too little, it is much easier to regulate to address problems once the crisis has fully manifested itself and much harder to move aggressively in good times when things appear to be going smoothly;

- TThe government's initial response in the lead-up to the full-blown crisis, the prevailing political climate, and the political will for aggressive regulation in that time period is critical.

Introduction

'I sincerely believe that banking establishments are more dangerous than standing armies.'
Thomas Jefferson

This paper will explore how governments respond to financial crises by looking at one particular financial crisis, the Savings and Loan Crisis of the 1980s and early 1990s, the largest banking crisis since the Great Depression. One study called it the worst public scandal in American history.

The Early Years

The first savings and loan (S&L) association (also called thrifts) in America was founded in 1831 in a small town outside of Philadelphia. The initial S&Ls arose out of concerns of neighbours and co-workers to provide some support for other neighbours or co-workers to be able to build their own homes. The purpose was not to engage in traditional banking, but rather to accept deposits and provide residential mortgages; thrifts could not offer other services generally associated with banking, such as checking. Until the second half of the twentieth century, S&Ls were generally owned by their depositors. This was an unstable structure that nonetheless survived; at its height in the 1920s, there were approximately 12,500 thrifts in the US. The focus on home mortgages was viewed as a niche part of the financial industry, creating two divergent views of S&Ls. The general public, and many politicians, had a very favourable view of thrifts as helping regular people buy homes, as reflected in the movie, *It's A Wonderful Life*. For many in the financial industry, however, S&Ls were considered unsophisticated dinosaurs, run by small-town rubes.

The Great Depression

The regulatory structure for thrifts that lasted until the S&L crisis was put in place during the Great Depression. The Federal Home Loan Bank (FHLB) was created in 1932 and consisted of twelve regional banks owned by the S&Ls in that geographic region. The FHLBs provided credit to those thrifts to enable loans to persons looking to purchase homes. In 1934, the Federal Savings and Loan Insurance Corporation (FSLIC) was created to insure the deposits of thrifts.

The regulatory structure for thrifts was in the quasi-public Federal Home Loan Bank Board (FHLBB), a different regulatory framework than governed commercial banks, one that was also weaker than for the other banking agencies. In the FHLBB, supervision was decentralized and split from the examination function. Supervisory agents were employed by the FHLBs, private entities, that were owned by the institutions they supervised and the agents were paid very well. Thrift examiners were federal employees, paid by the Office of Management and Budget (OMB), on wages far lower than either supervisory agents or examiners at the other Federal Banking Agencies. Examiners were the analysts who went into the thrifts to look at books and records; supervisory agents were the persons back home who decided what to do with or about what the examiners found. This dichotomy bred mistrust and suspicion between the two groups. Supervisory agents thought that examiners were low-paid specialists in trivial details; examiners thought that supervisory agents were overpaid hacks too friendly to the industry they were regulating. Until 1984, the FHLBB had limited resources and only five enforcement attorneys. Its focus was on the institution's compliance with laws and regulations, not safety and soundness of its operations. There was also a severe lack of resources for FSLIC, which made closing thrifts difficult as a practical matter.

Despite these tensions, the system worked well enough while S&Ls handled conventional home mortgages. From the 1940s until the 1970s, S&Ls went through a golden age, with very few failures and few problems of mismanagement. Because most thrift assets were fixed-rate mortgages, credit-quality problems were considered rare. From 1935 to 1980, only 145 S&Ls, with assets totalling $4.5 billion, failed. These numbers were about to be eclipsed.

The Crisis

The initial major problem and catalyst for the S&L crisis and much of what followed was the interest rate crunch of late 1970s. Thrifts had assets consisting largely of thirty-year mortgages garnering interest of around 6%, but interest rates, and what thrifts had to pay depositors, rose much more quickly. Other problems and developments, including the bursting of a real estate bubble in many parts of the US, and slowness in funding FSLIC, which delayed closing of many insolvent thrifts, also contributed to the initial crises.

The results: S&Ls were haemorraging losses. The industry became insolvent by $150 billion on a market-value basis and FSLIC has only $6 billion in reserves. For most of the 1980s, FSLIC lacked the resources to handle most of the thrifts that either were insolvent or appeared likely of becoming so. From 1980 to 1982, 118 thrifts with $413 billion in assets failed.

The Regulatory Response

Stage One: Deregulation

The initial response to the S&L crisis was one of deregulation, driven by two main considerations. First was the general deregulatory zeal of Ronald Reagan and his administration (although deregulation actually started under the Carter administration). Those in the Reagan administration responsible for dealing with the S&L problem 'crafted the policies of deregulation and forbearance and adamantly opposed any governmental cash expenditures to resolve the S&L problem'.[1]

Second, policies that did not add to the federal deficit were favoured so that every effort was made not to close thrifts, regardless of how insolvent they might be. Great pressure was placed on the FHLBB to use any means to 'resolve' troubled institutions that would not increase the budget deficit, as closing institutions would.

One prominent view was that once interest rates adjust and lower, thrifts would grow out of the problem; bottom lines look bad, but they are basically paper losses. The chairman of the FHLBB at the time, Richard Pratt, was a firm believer in deregulation as the key solution.

Deregulation came from both Congress and the FHLBB. Key features of deregulation included laws and policies aimed at eliminating many of the distinctions between thrifts and commercial banks, notably expanding the authority of S&Ls to make loans other than home mortgages, particularly construction loans, allowing the use of brokered deposits, and relaxing the net worth requirements of thrifts and the limitations on ownership such that a single person or entity could own a thrift.[2] Limits on what interest S&Ls (and banks) could pay depositors were removed and thrifts were allowed to buy securities. The amount of insurance protection for individual depositors was raised from $40,000 to $100,000. This is more important than it seems at first blush. The average depositor of S&Ls in 1980 had about $6,000 in his account. The leap to $100,000 in deposit insurance was not for depositors but for the thrifts, to enable them to attract large sums that could be used for lending and for speculative ventures. Thrifts were also authorized to use 'bank' in their names and to offer checking accounts, further blurring the distinction between thrifts and banks.

Thrifts were also allowed to use very favourable accounting treatments, known to proponents as Regulatory Accounting Principles, or RAP, and to their critics as Creative Regulatory Accounting Principles (CRAP), including permitting thrifts to defer recognition of losses from delinquent loans. The FHLBB also allowed troubled S&Ls to issue 'income capital certificates' and Net Worth Certificates for purchase by FSLIC and count them as capital, which masked solvency issues. And, to encourage resolution of troubled thrifts without closing them, healthy thrifts looking to acquire troubled ones were allowed, as a matter of accounting, to treat the losses at the troubled thrifts as 'supervisory goodwill' and count it as capital.

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The cornerstone of this effort was the Garn St. Germain Depository Institutions Act of 1982, which Reagan called 'the Emancipation Proclamation for

1. See: ‹http://www.fdic.gov/bank/historical/history/167_188.pdf› at p. 177. Last accessed 17 February 2011.

2. Prior to this period, an S&L had to have at least 400 shareholders, 125 of whom had to be local, with no individual owning 10% of the stock, and no group owning more than 25%.

America's savings institutions'. A later assessment desribed it as a nuclear attack on the industry. Some measures not even aimed at the S&L crisis affected it as well, such as changes in the tax laws that made real estate investments more attractive. Changes in regulation made it so that one person could own an S&L and could use brokered deposits and other accounting features to grow aggressively. Interestingly, while the S&L industry generally liked the direction Pratt was taking the Bank Board, it did not favour complete deregulation; it liked the special laws and rules that protected thrifts and gave them powers banks did not have. The industry's powerful lobbying arm, the United States League, also pressed (unsuccessfully) to have the government purchase the troubled assets of thrifts.

Deregulation raised a question: do fewer rules require more aggressive oversight or less? Different people had different answers, but the latter view prevailed at the FHLBB initially. The FHLBB occasionally but rarely took over a troubled institution. The general view was that if a thrift had cash on hand to meet its day-to-day business needs (payroll, etc.), it should be kept alive despite the long-term picture. This is contrary to the generally accepted view that a bank with positive long-term prospects might receive a temporary infusion of capital if there was a temporary cash-flow problem. Did the reforms 'work'? Prompted by an improved interest rate environment, 1982-85 was a period of great growth. The number of thrifts expanded and many thrifts grew dramatically. From 1982 to 1985, industry assets increased from $686 billion to $1,086 billion; forty Texas S&Ls tripled in size between 1982 and 1986. Federal thrifts grew at more than twice the rate at which banks did in this period.

But the growth was often only on paper and illusory, especially for the 'high-fliers': those thrifts that grew the fastest with the most aggressive growth and lending plans. While the thrifts grew, the FHLBB examination staff did not. In fact, Pratt reduced the number of examiners and of examinations, and the average examiner had only two years on the job. Many state-chartered S&Ls flipped to federal charters, prompting a number of states to enact legislation relaxing regulation to lure thrifts back, a classic example of the regulatory race to the bottom. In California, the Nolan Bill allowed S&Ls to invest 100% of deposits in any kind of venture.

Ironically, some of the measures adopted in the early 1980s to address the major cause or at least the starting point of the S&L crisis (the interest rate crunch) contributed to other factors later identified as causative of the crisis. For example, reduced net worth requirements made it easier to get a federal thrift charter, leading to too many people getting thrifts; deregulation reduced capital requirements and allowed thrifts to get involved in different types of loan products and to purchase junk bonds and mortgage-backed securities. Many measures hid insolvency, and the relaxed restrictions meant that there was no risk for depositors and almost no risk for thrift executives.

As one study summarized:

> *With money flowing so plentifully, risk takers gravitated toward the S&L industry, altering ownership characteristics. Although more than a few of these new owners engaged in highly publicized cases of fraud, many others were just greedy. Sharp entrepreneurs realized the large potential profit from owning an S&L, whose charter now allowed a wide range of investment opportunities without the corresponding regulation of commercial banks. Little capital was required to purchase or start an S&L, and the growth potential was great. A variety of new bankers entered the S&L industry, ranging from dentists with no experience in owning financial institutions, to real estate developers, who had serious conflicts of interest.*[3]

3. See: ‹http://www.fdic.gov/bank/historical/history/167_188.pdf› at pp. 178-79. Last accessed 17 February 2011.

Between 1980 and 1986, 500 new S&Ls opened. Of the seventy-two thrifts taken over from 1985-87, half were owned and operated by persons new to the industry. Most of the new charters were stock institutions (as opposed to depositor-owned institutions); by 1986, stock institutions were nearly 40% of all thrifts, and controlled 64% of the industry assets.

And while most thrifts continued to be run by career, honest, professional bankers and to offer mostly conventional home mortgages, many thrift operators – particularly the newest, fastest growers – began to offer new types of loans. Most prevalent among these were Acquisition, Development and Construction (ADC) loans. These were loans, usually to real estate developers, to acquire and build residential or commercial units. But frequently, these loans contained other unconventional features: no down payment, interest-only payments until maturation, large up-front fees, fees and interest funded by the S&L, the developer's profit built into the loan and paid up front, and use of the real estate for which the loan was obtained as the collateral. Often the developer had no personal liability on the loan and agreed to no significant personal guarantees. Not surprisingly, these loans were often made to projects owned by bank officials.

ADC loans created fictitious profits and masked real risks and losses. These features allowed S&Ls to book immediate profits, even though all of the money was their money, not the borrowers. These kinds of ADC loans were very risky, but on paper indicated (falsely) that the S&L was hugely profitable. In fact, the loans were only profitable if the project actually was completed and fully sold or rented out, but the developer had no risk if it did not.

Many ADC loans are charitably described as risky if not outright frauds. Other new practices were more clearly fraud. These included:

- Cash for trash: S&Ls lend to a borrower on the condition that the borrower use part of the proceeds to buy bad loans from the thrift; this allows the thrift to take bad loans off its books (and recognize points and fees as income) and show a profit, but the institution's money is still at risk;

- 'Dead horse for a dead cow': S&Ls buy each others' bad loans: this allows each to show a profit and take a loss off its books temporarily; there were other variations on this theme, such as reciprocal lending (you lend to me, I'll lend to you);

- Land flips: S&Ls provide a mortgage for a home buyer, who then sells to another buyer (usually a friend or relative and sometimes a straw or nominee borrower) based on an inflated appraisal; this is repeated many times over a short span until the ultimate purchaser is stuck with a piece of property that is wildly over-valued. One examiner was told by a bank official about a set of transactions in which the property was re-sold and re-financed six times. When the examiner objected, 'That's horrible', the bank officer replied, 'Only if you are the sixth buyer'.

In many instances, thrifts not only eschewed traditional mortgage loans, but avoided lending altogether. S&Ls were investing 'in everything from casinos to fast-food franchises, ski resorts and windmill farms'.[4] Some thrifts invested heavily in junk bonds and arbitrage schemes. The 1980s were marked by a declining percentage of thrift assets in traditional mortgages: from 78% in 1981 to 39% in 1988.

Deregulation not only gave rise to new lending and investment strategies but attracted some real characters to take advantage of those new opportunities, not all of them interested in running a legitimate financial institution. Some came to achieve some measure of fame or notoriety, such as Don Dixon, of Vernon Savings Bank in Texas (also known as 'Vermin Savings Bank'), who specialized in ADC loans, particulary for his own projects, many of which were for six months so that they had to be re-

4. Ibid., p. 180.

financed and would generate additional fees. Dixon had Vernon pay for a bevy of lear jets, lavish personal homes for him in California and Colorado, and a trip to Europe to dine in three-star rated Michelin restaurants (which trip came to be called 'Gastronomique Fantastique'). When challenged about the expenses associated with the trip to Europe, Dixon said the bank was considering a loan to a French restaurant and had to assess the borrower's business.

Another was David Paul, of Centrust in Miami, Florida, who had the thrift purchase numerous pieces of very expensive art, most of which he kept in his own home, and a sailboat. Paul built the bank's offices into a grand structure that to this day is a central defining structure on the Miami skyline. Paul also had a yacht in Washington that was used to entertain politicians.

One thrift run by a former airline pilot won acclaim as the fastest growing, most profitable thrift in the country, growing from $11.7M in assets to $1.1B in a few years. At one point it stopped making loans altogether and its assets were mostly windmill farms, a chicken farm, shopping centres, condominiums, and $300 million in junk bonds. It closed its storefront bank and operated out of office space in a high-rise at which it did little more than make its questionable investments.

Many thrift executives awarded themselves extravagant compensation packages, regardless of the performance of their institutions. The practice of executives' using their thrifts to pay for expensive personal items and expenses became known as treating their thrifts as a piggy bank and a frequent subject of criticism by regulators.

Also involved were lawyers – one thrift executive observed that for half a million dollars you could buy any opinion you want from any law firm in New York

Thrift officers were assisted by many outside the institution in these questionable and often fraudulent practices. Central were accountants, who blessed the worst aspects of ADC loans and the efforts to conceal the risks, and appraisers, many of whom learned that the only way to earn more business was to come up with appraisals that matched the numbers the thrift executives needed. Appraisers were also key players in land flips. Also involved were lawyers (one thrift executive observed that for half a million dollars you could buy any opinion you want from any law firm in New York), Wall Street investment houses, and academic economists who worked on 'projects' for the thrifts and the industry that often derided regulation.

All of these players encouraged a large number of ADC loans that should never have been made and required especially high interest rates offered to depositors to attract funds. These loans not only caused losses at the thrifts that made them, but also created huge competition for legitimate loans made, and interest rates offered, by traditionally run S&Ls. Beyond that, however, the favourable-looking bottom lines not only masked serious problems but conversely served, as a practical matter, to limit the regulatory response. As one observer asked an FHLBB official who was considering whether to close one of the high-flying thrifts that, despite its problems, was reported to be the most profitable thrift in the country, 'Do you want to go into court and explain shutting down the most profitable thrift in the country?'.

It must also be noted that prominent players in major S&Ls were not hesitant to use political connections to try to forestall regulators. This became a major scandal for some of the most prominent thrifts, as reflected most notoriously in the efforts of Charles Keating of Lincoln Savings to enlist five United States Senators (the Keating Five) and of Texas thrift executives to seek help from the powerful Speaker of the US House of Representatives, Jim Wright, to get the FHLBB to back off. Also emblematic were the large amounts of political campaign contributions made by thrift executives and their political action committees. One official opined that the S&L crisis was more of a political problem than a financial crisis.

The problem, however, was not simply one of fraud by officers at some of the fastest growing thrifts. The new powers and products presented challenges to competence as well as honesty. FHLBB examiners were trained to examine traditional mortgages. But new asset powers and the much more complex financial world in which S&Ls now operated were beyond the training and expertise of the examiners, who were understaffed and poorly trained for this new environment. And low compensation led many examiners to take jobs working for the thrifts.

But FHLBB examiners weren't the only ones who didn't fully understand the new products. The same could be said of many of the executives of thrifts who had always managed the safe, home mortgages thrifts were historically known for and didn't understand the new products and opportunities either. In addition, the tremendous competition for borrowers and profits fuelled by the housing boom led to lax underwriting standards. One example illustrates the point. A thrift not previously involved in commercial real estate lending was approached by a mall developer for a loan. The loan officer offered to make the loan once he reviewed the developer's business plan. The developer insisted (probably accurately) that he could get the loan without producing a business plan at another bank elsewhere in town and told the loan officer that he had a few minutes to decide whether to make the loan. The officer did, without the plan; the project ultimately went bust. Other questionable practices included loan originators whose compensation was all bonus based on volume, paid immediately upon loan closing, with no consideration of how the loans actually performed.

Thus was presented a toxic combination: new owners not really interested in the traditional functions of an insured depository institution, plus traditional owners who didn't understand what they were getting into. Even for those who were not corrupt, this was a different industry than the one that gave rise to S&Ls. One seminar offered after the passage of the Garn St. Germain bill was titled 'How to Use the New Legislation to Get Rich'. There was a longstanding observation that nobody made money running an S&L. That was not the philosophy of many in the business in the 1980s.

In short, broadly speaking, no group – not thrift executives and industry leaders, lawyers, accountants, appraisers, regulators and politicians – came out looking good in the crisis.

Stage Two: Re-regulation

Despite more thrifts, many with attractive bottom lines, problems still existed in the mid-1980s. The accounting tricks allowed some thrifts to hide problems, not cure them. Over the next couple of years, thrift failures in a couple of states – most prominently the 1984 failure of Empire Savings in Texas caused in part by land flips and other criminal conduct, and a large number of failures in Maryland which depleted the state insurance fund, and in Ohio that prompted the governor to declare a bank holiday – foreshadowed larger problems.

Under the surface, the picture for the S&L industry had not really improved. In truth, it was arguably getting worse. Thrifts were not really generating the revenues suggested by accounting tricks that hid losses; most of the fastest-growing thrifts were doing so with brokered deposits and ADC loans that masked losses and failed to generate real income, and by investing in mortgage-backed securities and junk bonds. Many thrifts, especially the largest, if measured by traditional accounting measures and the real value of their assets, were insolvent. This marked an important shift in the S&L crisis: what had started as a problem of interest-rate risk had become more one of bad assets. The FSLIC still was vastly underfunded to cover the risk.

At the FHLBB, Ed Gray replaced Richard Pratt. Gray had worked for Ronald Reagan in California in the press office and then worked for a thrift in California. He was both fiercely loyal and, at first, a big believer in deregulation. In fact, he was given the job precisely because he was expected to be a team player and continue deregulation. But Gray came to see the problems in a way that Pratt and others in the administration never had. Early in his tenure he was shown a videotape of row-after-row of unfinished or unoccupied buildings financed by Empire Savings. Gray was horrified by the film and became convinced that deregulation was not working.

Gray led efforts by the FHLBB and other regulators to try to contain the problems. The key change was to reinstate significant limits to the direct investment rule. The FHLBB also raised the net worth requirement for newly chartered S&Ls and limited the amount of brokered deposits for institutions failing to meet net worth requirements. An effort by the FHLBB and FDIC to try to eliminate deposit insurance for brokered deposits was rejected by a federal court.

Internally, examiners were transferred to FHLBB from OMB so that salaries would be more competitive. This allowed Gray to recruit top talent, beefing up the staff with skilled people who bought into his philosophy of aggressive regulation. Examiners obtained authority to classify loans and there was a significant increase in enforcement actions.

Were these honest efforts to deal with the problem or just band-aids? Gray generally comes off favourably in many of the few in-depth studies of the S&L crisis. For some, he is a true hero; for others, his efforts earn him praise, although his shortcomings get mentioned as well. One thing that undermined Gray was his very lavish use of FHLBB resources to travel and meet with FHLBB personnel, lobbyists, and thrift executives.[5] For another, Gray's background was in public relations. While he believed that more regulation and supervision was necessary, he tried to do it in an amicable way. That did not work, alienating both sides.

5. Perhaps ironically, the FHLBB was funded by assessments on the thrifts it regulated. The more thrifts reported profits, even illusory profits, the more resources available to the FHLBB.

The economics of the industry continued to deteriorate. In 1985, 434 thrifts were insolvent and 850 were on the brink; about a third of the industry was in trouble. In 1985, FSLIC had $4.6 billion in reserves, but thrifts that were actually insolvent would cost $300 billion if closed. The inability to close insolvent thrifts was creating a category of 'zombie' thrifts that did little more than continue the practices that had gotten them in financial trouble. Industry losses in 1987 were $7.8 billion, a record up to that time ($3 billion higher than the last high in 1981); industry profits fell from $3.7 billion in 1986 to $32 million the next year. A 1987 Government Accounting Office (GAO) report found that 70% of the thrifts that had taken advantage of relaxed accounting rules and government notes had actually gotten worse; one-third of the industry was insolvent, and another third was in serious financial condition; only a third of the industry was healthy by conventional measures. By then, Gray had acknowledged that FSLIC was insolvent. The GAO agreed.

Stage Three: Deregulation Makes a Comeback

Gray's efforts at 're-regulation' created many enemies, both in the industry, including its powerful lobby, and in the White House, which still viewed deregulation as the key. Efforts to fire Gray failed but his re-appointment was out of the question.

Gray was replaced as head of the FHLBB by M. Danny Wall, former Chief of Staff to Senator Jake Garn. Wall was a believer in deregulation who thought that Gray's efforts at re-regulation had contributed to the problems of the industry and perhaps even created the crisis. Wall was a huge believer in 'successful' businessmen and accepted thrift executives' complaints about overly aggressive FHLBB staff, even when those complaining were steeped in fraudulent ADC loans, junk bond purchases, and the other tactics that were causing the problems.

Wall's tenure as head of the FHLBB was marked by an effort to be more optimistic and end Gray's 're-regulation'. Examinations and enforcement actions were fewer and forebearance increased. Some measures that Gray proposed that Wall did not reverse he nonetheless delayed implementing. Wall also resisted calls for uniform appraisal standards; he told each thrift it could decide for itself what standards to use, making fraud that much easier.

Wall continued the administration's efforts to deal with troubled thrifts by any means short of closing them. In late 1988, using statutory authority that would expire by year's end, he worked to find acquirers for troubled institutions on terms that were ridiculously favourable to the acquirers. With the time available to complete these deals short, negotiations were conducted at a hectic pace, with potential acquirers all too aware of Wall's desire to reach agreement. In one high-profile deal, the acquirer received so much in tax breaks and financial assistance from the FHLBB that he made more in tax breaks than he paid to purchase the thrift. Another acquirer received $4.8 billion in government subsidies and used a lot of that money to buy junk bonds. Another had to put in only $1000 of his own money and $70 million in borrowed funds and was given $1.8 billion in government assistance. Each of the thifts involved in these and the other sweetheart deals failed nonetheless, costing an additional $80 billion. Some derisively called these transactions 'Wall paper' and 'McDeals', and described the process as Robin Hood-in-reverse.

One issue that spanned Gray's and Wall's tenure was the effort to press Congress for funds to recapitalize the FSLIC. These efforts produced wildly varying estimates from the FHLBB as to the true cost of dealing with the S&L crisis. Estimates by both Gray and Wall were generally very low and never higher than $30 billion, much lower than estimates by other federal agencies and private analysts, which ranged from $60 billion to $100 billion. One FHLBB economist complained about some of the accounting tricks used by Wall to arrive at his cost estimates and was told by a staffer, 'If you don't like our numbers, don't come to our meetings'.[6] Ultimately, these varying estimates did little more than to discredit the FHLBB. FSLIC was eventually recapitalized, but with an amount far less than needed, and with provisions added to delay or prevent S&L closings.

In one high-profile deal, the acquirer received so much financial assistance that he made more in tax breaks than he paid to purchase the thrift. Another acquirer received $4.8 billion in government subsidies and used a lot of that money to buy junk bonds. … Some derisively described the process as Robin Hood-in-reverse.

Even more important, people began thinking about one component to resolving the S&L crisis that at the beginning of the decade was nearly unthinkable: taxpayer assistance in bringing the industry back to health. Well-run solvent thrifts were getting tired of paying additional in assessments because of the questionable tactics of their poorly run competitors, and the industry's powerful lobbying organization, the United States League was eager to receive help from taxpayers.

Lincoln Savings and Charles Keating as a Test Case

Danny Wall's approach to thrift regulation is revealed in his treatment of Lincoln Savings Bank, owned by Charles Keating, which illustrates a lot of the forces that were at work in the 1980s.

Until the 1980s, Lincoln Savings was a profitable, family-owned, and traditional S&L. Lincoln experienced some troubles from the interest rate crunch of the late 1970s, but by 1983, the thrift was profitable.

Charles Keating first came to national prominence as an anti-pornography crusader in the Midwest. Keating had previously associated himself in business with someone who had run-ins with the regulators. Keating's own prior conduct in finance led to a

6. Day, K. (1993) *S&L Hell: The People and Politics Behind the $1 Trillion Savings and Loan Scandal.* New York: W.W.Norton & Co.

Consent Order with the Securities and Exchange Commission following accusations of fraudulent insider loans; in executing the Order, Keating made no admission of guilt. Ultimately, Keating wound up as head of American Continental Corporation (ACC), a real estate development company, and in the early 1980s decided to purchase a thrift. Ironically, Keating was attracted to Lincoln in part by FHLBB's touting of the advantages of a thrift charter. Keating aggressively pursued Lincoln. As part of the deal, Keating promised the owners of Lincoln to keep business the same – concentrating on home mortgages in Southern California – and to keep all of the employees, making that part of his business plan submitted to the San Francisco office of the FHLBB.[7]

Those promises were dashed almost immediately, as Lincoln essentially opted out of the home mortgage business and instead invested heavily in speculative securities and real estate developments, as well as ADC loans and other questionable investments including a host of unprofitable hotels. Lincoln also did some junk bond swaps with David Paul, participated in exchanges of bad loans with other high-fliers and engaged in a series of speculative and risky stock transactions funded by Lincoln, the benefits of which were paid to ACC or Keating directly. In contrast, Lincoln made only eleven standard home mortgages in 1984 and 1985, less than 2% of its lending portfolio, and four of those mortgages were to Lincoln employees.

Lincoln also sold highly risky ACC junk bonds out of the lobby of Lincoln Savings. Representatives of ACC targeted depositors, often elderly customers, coming in to re-new certificates of deposits. Playing off of the fact that Lincoln's deposits were federally insured, they pitched that while Lincoln was strong because of the insured deposits, they insisted, falsely, that ACC was even stronger, leading many unsophisticated investors to believe that the junk bonds were insured by FSLIC.

Keating's plans for Lincoln clashed with Ed Gray's FHLBB almost immediately. Just a few days before the sale of Lincoln was consummated, Gray introduced his measure to limit direct investments. This struck at the heart of what Keating wanted to do.

To get around Gray's direct investment rule, Keating attempted political pressure. Keating has been described by a former FHLBB lawyer as 'a political force of nature the likes of which none of us, including Wall, had ever seen'.[8] (A few years later, Keating was asked whether his political contributions were helping him deal with regulators, to which he replied, 'I want to say in the most forceful way possible: I certainly hope so'.) Using a lobbyist as the conduit, Keating manoeuvred to have Gray and his top aides questioned by the House Banking Committee, chaired by Representative John Dingell, who had treated the FHLBB representatives aggressively and dismissively in the past. Gray and his folks had been through numerous such hearings and usually got beaten up pretty badly.

This time Gray and the others from the FHLBB changed strategy and instead of trying to explain or justify past conduct, they promised aggressive enforcement actions going forward. This was exactly what Dingell and others wanted to hear. Keating's initial political strategy backfired. Rather than backing off, Gray and his staff were emboldened to stay tough.

By 1986, Lincoln was in serious financial trouble due to loans that were not performing and accounting tricks that made it look like the loans were actually profitable. Things got so bad that by 1988, even Lincoln's outside auditors refused to sign off on some of the practices, leading Lincoln officials to (falsely) assure the auditors that the regulators had approved the transactions, while at the same time telling the FHLBB that the transactions had been blessed by Lincoln's auditors.

7. Although Keating purchased Lincoln, he was never officially an officer or director of Lincoln; he did, however, essentially run the institution.

8. Black, W. K. (2005) *The Best Way To Rob a Bank Is To Own One*. Austin, TX: University of Texas Press.

Lincoln's departure from the business plan caught the attention of the San Francisco office of the FHLBB (FHLBBSF), which had initial and primary supervisory responsibility for Lincoln Savings. The FHLBBSF was one of the best offices of the FHLBB, a prime beneficiary of Gray's efforts to attract the most aggressive and talented people he could find. An FHLBBSF examination of Lincoln in May of 1987 revealed many problems such as poor underwriting and excessive compensation, and some actions on the part of Lincoln officers and employees that were blatantly illegal, including file stuffing and forging documents to make loans look sounder than they actually were.

Following the May 1987 examination of Lincoln, FHLBBSF recommended to Gray that Lincoln Savings be placed in a conservatorship. This came two months before Gray's term was over so he decided he could not authorize it. But before he left, he advised Wall about the recommendation. Wall never brought that recommendation to the full Board.

In September 1987, FHLBBSF informed Lincoln that it would start a field visit of the institution. Lincoln sued FHLBB to prevent the field visit. As a legal matter, Lincoln's chance of prevailing on that lawsuit was negligible; if there is one thing regulators have legal authority to do it is to examine the institutions they regulate. Nonetheless, in an unprecedented move, Wall stopped the field visit and suspended it indefinitely. Keating managed to hold off any examination or effective supervision of Lincoln for the rest of 1987, until 1988.

Throughout this process, Wall met repeatedly with representatives of Lincoln, and not only refused to have FHLBBSF personnel familiar with the condition of Lincoln or the concerns raised in the last Lincoln examination at those meetings, but in fact never once met with FHLBBSF personnel familiar with what Lincoln was doing.

Instead, Wall submitted the examination findings and concerns about Lincoln prepared by FHLBBSF to an independent group within the FHLBB who, again, never meet with their FHLBBSF counterparts. However, those conducting the independent review concluded that the findings of FHLBBSF were correct; if anything, the reviewers were critical that steps to shut down Lincoln had not been taken faster.

Keating then tried to move regulatory supervision of Lincoln out of FHLBBSF. He offered to buy a thrift in the Seattle region of the FHLBB if that office would take over supervision of Lincoln. FHLBB Seattle, however, agreed with the findings of FHLBBSF concerning Lincoln and refused Keating's offer. So Keating turned to FHLBB headquarters in Washington DC, and Wall eventually agreed to move supervision of Lincoln to main headquarters.

All of these actions by Wall – suspending the field visit, meeting only with Lincoln representatives without FHLBBSF personnel, allowing Keating to try to select his regulator – were in both perception and reality serious efforts to undermine supervision and regulation, potentially very bad precedents. They were also unsuccessful for Keating. Eventually, Wall's efforts to avoid the FHLBBSF findings ran into too much resistance and the determination was made that something had to be done to address what was going on at Lincoln.

Wall rejected the idea of closing Lincoln and decided on trying to have his staff negotiate a stringent Cease & Desist Order to curtail Lincoln's worst practices. Keating understood that even this lesser measure would reveal all of the fraud at the institution and continued to fight. Lincoln went so far as to sue key members of FHLBBSF personally, although those lawsuits were ultimately unsuccessful. Throughout his battles with FHLBB, Keating used eighty of the largest law firms in the US.

Keating also attempted political pressure, persuading five US Senators to intercede on Lincoln's behalf to stop the FHLBB efforts. Those senators came to be known as the Keating Five, a label that for one of them – John McCain – would be used against him during his campaign for the presidency twenty years later.

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The FHLBB in DC eventually conducted negotiations with Keating over a Cease & Desist Order without any of the personnel from FHLBBSF who knew Keating, knew the problems facing Lincoln. The resulting Cease & Desist Order was essentially toothless. ACC agreed to contribute $10 million in capital and agreed to recognize a small number of minor accounting adjustments. But, the Order also:

- Allowed Lincoln to continue with direct investments, notwithstanding the rule that would otherwise have outlawed them;

- Allowed Lincoln to continue to grow using high-risk assets, including junk bonds;

- Provided that nothing from the earlier examination could be used as a basis for an enforcement action against Lincoln, nor could the FHLBB bring an enforcement action even if it independently verified any of the wrongdoing;

- Provided that Lincoln would be given advance notice of the examiners who would examine the institution and that Lincoln could object to any it did not like.

The negotiations also resulted in a side letter from the head of Enforcement for the FHLBB, Rosemary Stewart, which assured that no criminal referrals or referrals to the Securities and Exchange Commission (SEC) would be made regarding what FHLBB had found at Lincoln.

The Cease & Desist Order was everything Lincoln and Keating could have hoped for. The day it was signed, Keating threw a big party in ACC headquarters in Phoenix. On the other side, the Order also drew criticism of other agencies that saw it as interfering with efforts on their parts to go after Lincoln. The Order came to be called 'Rosemary's Baby'.

The beginning of the end for Lincoln and Keating came in the next examination in 1988. This was again marked by efforts by Lincoln to control the examination. Lincoln refused to allow any FHLBBSF examiners to participate in the examination, and FHLBB in DC acceded; the resulting FHLBB examiners were inexperienced and with no real knowledge of Lincoln's past conduct. Lincoln also refused to let the examiners have access to the prior Report of Examination, although the examiners eventually got some access.

However, the FHLBB examiners were joined in the examination by examiners from the state of California who found the smoking gun: a Tax Sharing Agreement (TSA) Lincoln signed with ACC. Under the TSA, money was upstreamed from Lincoln to ACC as part of an arrangement to pay taxes in a joint return. The trouble was that the money was sent from Lincoln to ACC before tax liability was known. Moreover, in fact, ACC did not owe any taxes and the payments were just efforts to have Lincoln send money to its parent. That violated regulations that forbade loans between Lincoln and its parent, ACC.

The TSA was the beginning of the end for a couple of reasons. First, Keating had assured FHLBB senior officials that he had not taken a dime out of Lincoln; the TSA showed this to be false. And ACC was shown to be insolvent, which meant that it would not be able to repay the money to Lincoln, which would cause Lincoln to fail its net worth maintenance requirements. Unravelling the TSA also revealed many of the other worms when the Lincoln rock was turned over. Further investigation led the FHLBB to see that the 'profits' being reported by Lincoln as part of the tax payments were based on 'cash for trash' transactions and other phony deals to suggest profits where there were none. This would require Lincoln to reverse those profits, which would reveal it to be insolvent. Finally, the investigation revealed that ACC had engaged in sales of stock mostly to elderly customers through sales at Lincoln branches discussed above. This fraudulent stock scheme was going to turn problems with Lincoln from an S&L problem to a criminal matter and a political scandal because of the vulnerability of the victims.

The pressure on FHLBB to shut down Lincoln was now unavoidable. Even Wall was forced to shut down Lincoln in April of 1989. Keating ultimately faced both civil and criminal charges from the FHLBB's successor, Department of Justice (DOJ) and the SEC. Just as Keating and his outsized plans for Lincoln were not typical of all thrifts in 1980s, Danny Wall's efforts to address what the FHLBBSF and Ed Gray had found at Lincoln were also extreme. But in both instances, the differences between how Keating and Wall each dealt with Lincoln and how other thrifts operated and were dealt with by the regulators can arguably at some level be described more as differences in degree than kind.

Stage Four: The Bush Years

The final effort of the government to address the S&L crisis was the mirror image of most of what had gone before: a much more aggressive effort aimed at increased regulation and enforcement actions, including the closing of insolvent thrifts. In 1989, Congress passed the Financial Institution Reform, Recovery and Enforcement Act (FIRREA), one of the first major initiatives of the first Bush administration. Among its key provisions: supervision and enforcement were moved out of FHLBB[9] to a new office within Treasury – the Office of Thrift Supervision – and insurance deposit was shifted to the FDIC. Some provisions attempted to cure problems of the 1980s, such as imposing the same capital requirements as banks faced and adopting Loans-To-One-Borrower limits in hopes of eliminating the lending relationships seen in Texas where thrifts were overexposed to one builder. Purchases of junk bonds were prohibited and there were also restrictions on transactions with an institution's affiliates and holding brokered deposits. And thrifts could no longer count losses of institutions they had acquired (supervisory goodwill) as capital.

Most important were enhanced enforcement powers such as new remedial powers including the ability to impose growth restrictions, rescind contracts, dispose of assets, insist that employees be qualified, and a catch-all: any other relief the agency believes is necessary. Civil money penalties could now be imposed in amounts up to $1,000,000 per day. And a new administrative court was established specializing in financial enforcement actions. These changes were not as dramatic as those passed during the New Deal, but they were important.

Just as important was the perception and reality of more aggressive enforcement authorized by Congress and pursued by OTS. A new enforcement structure was created and more attorneys hired. A provision of FIRREA preserved enforcement jurisdiction over officers and directors of thrifts who were no longer with the institutions they had served, reversing a court decision that had limited the banking agencies' authority to pursue persons who were no longer employed at the institutions at which they had engaged in misconduct. Enforcement actions more than doubled, involving a wide range of behaviour, from self-dealing to the funding of officers' questionable real estate projects. Most actions went after senior officers of institutions, but OTS also went after major shareholders, directors, lawyers, and accountants when the facts warranted.

Public outcry created pressure to go after fraud and the big names. Was fraud the main problem in the S&L crisis? Estimates varied. Some insisted that fraud was the driving cause of the S&L crisis, others said it accounted for a very small part of the problem. Government studies have estimates that are all over the place: one study of failed thrifts estimated that fraud or self-dealing accounted for one-third of the

9. The Federal Home Loan Banks were untouched.

problems; another put the range at between 25% and 75%, which may just reflect how difficult it is to agree on and measure fraud and insider abuse. The correct assessment is probably somewhere between the extremes. Mismanagement was probably a greater factor than outright fraud, although fraud and insider abuse were significant. Fraud and mismanagement are also not mutually exclusive. Moreover, fraud was the dominant public face of the crisis and drove resources; also, if you consider the largest frauds, the most losses were in the frauds.

Other agencies also responded. FIRREA provided additional resources — at first $75 million and then $162 million — for the DOJ, which created a Financial Institutions Fraud Unit and for a period focused on bank fraud. Early on there was some attempt to coordinate efforts between OTS and DOJ, but the agencies always worked their own investigations alone.

Just as important as change among the regulators, attitudes of the industry and public changed. Some complained that OTS moved too quickly or aggressively. But many of the executives at the well- or honestly run thrifts, who felt dragged down by the most corrupt and incompetent thrifts, at first actually welcomed FIRREA and the enhanced regulatory effort. And, at least for a period of time, courts were generally receptive to OTS arguments as judges also came to terms with the new enforcement powers.

In this setting, enforcement cases could be easy to negotiate. In the immediate aftermath, respondents were far more receptive to criticisms and allegations of misconduct. Criminal defense counsel often wanted OTS to take aggressive action against their clients so they could use that as an argument to avoid criminal prosecution, arguing that the government had already pounded their client. And courts sometimes deferred to the judgment of the regulators to an extent not generally found in non-crisis times.

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The Role of the Criminal Law

Comments, assessments, and even criticisms of the government's response to financial crises frequently focus not only on the actions of the civil primary regulators for the industry but on the actions of criminal law enforcement as well. Many people are not satisfied unless those responsible for the crisis serve jail time, regardless of what sanctions the civil regulators might impose. This was no less true for the S&L Crisis, as reflected in the debates about how much fraud drove the S&L Crisis. It is for that reason that a couple of quick observations about criminal prosecutions as opposed to civil enforcement work are in order.

Prior to FIRREA, there were few criminal prosecutions for illegal acts at savings associations. There were a couple of reasons for this. For one thing, there were not that many referrals of possible criminal conduct to prosecutors and other law enforcement authorities; where possible, banks and FHLBB preferred to see thrifts work out their problems. Also, as discussed above, many of the illegal actions, as well as the significant profits and bottom line results on paper flowing from those actions, sometimes masked the frauds. The S&L crisis illustrates that fraud usually comes to light not in flush times, but when the economy declines and the rocks are turned over. There was also neither structurally nor historically smooth cooperation between prosecutors and civil regulators. And attorneys and investigators at the DOJ were not staffed or trained to deal with bank fraud and crime. However, after FIRREA there were many more criminal referrals. In 1989, even before OTS took over, there were 6000 criminal referrals, significantly more than in previous years. By mid-1991, DOJ was sifting through approximately 18,000 referrals.

There were also many more prosecutions. From October 1988 through May 1991, 765 persons were charged in major fraud cases, defined as those involving large losses, senior officials, or multiple schemes. According to one study, there were over 1000 'priority' felony convictions of senior officials and insiders as a result of the S&L crisis after FIRREA. But even post-FIRREA, results were mixed and show the limitations of relying on criminal prosecutions, as opposed to civil regulation, to address financial crises.

For one thing, criminal cases are hard to bring and can involve long investigations that last far beyond the time of the crisis. The rush of possible cases added to the difficulties. Even in the immediate aftermath of FIRREA when more resources were devoted to bank fraud, DOJ did not have enough staff to handle everything that came its way and was overwhelmed by the number of referrals of possible criminal conduct; some cases were lost because of statute of limitations.

Also, prosecutors bringing criminal charges must try their cases to juries and prove the elements of each offense beyond a reasonable doubt, as opposed to the much easier preponderance-of-the-evidence standard usually used in civil cases. That additional burden of proof can prove daunting, if not insurmountable, in many of the types of cases generated by the S&L Crisis. Those cases were usually complex; and the frauds often looked initially just like run-of-the-mill business transactions, difficult to detect and then to unwind. Because of the complexity of some of the situations, favoured criminal charges included excessive compensation, and the creation of false books and records. Prosecutors learned to focus on one or two key transactions, rather than trying to investigate or charge every possible act of wrongdoing.

As criminal law enforcement officials devoted more attorneys and investigators to bank fraud cases, some, if not many of the attorneys and agents were thrown into cases that they were not used to pursuing. Mortgage fraud cases frequently involved sifting through massive amounts of bank records, loan files, and other similar types of documents by agents and prosecutors who had little if any prior experience with those types of documents.

These types of cases were also not what jurors were used to. One prominent Texas thrift executive was acquitted on twenty-nine counts because, according to post-trial statements elicited from the jurors, the facts were complex and boring. In one case, prosecutors learned of a thrift executive who illegally diverted insurance premium rebates owed to the bank into his own personal account. As long as he moved the money electronically, prosecutors were reluctant to bring the case, fearing that it would be a difficult and boring case to present to a jury. At one point, in connection with one rebate check, the executive moved the money the old-fashioned way, at a teller's window. In doing so, he was caught on the bank's usual surveillance videotape. Law enforcement considered that new evidence to have much more jury appeal and then pursued the case.

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Two other elements discouraged or hindered criminal prosecutions. One was that many of the defendants or prospective defendants were 'pillars of the community', very successful, family-types. This made both prosecutors and jurors both slower to suspect wrongdoing and more inclined to give possible defendants the benefit of the doubt. Second, bank fraud cases in which the crime or fraud was committed by non-bank personnel were frequently built and prosecuted with the help and use of 'inside' witnesses, i.e., bank officers and employees. When the suspects were themselves officers and employees – especially an institution's CEO or CFO – it could be much more difficult to secure the help of bank insiders. Even if lower-level employees knew of fraud or misconduct by their bosses, they could be reluctant to blow the whistle on persons who could – if nothing came of the accusations – demote or fire them.

According to one prominent study, the focus of the DOJ in these post-FIRREA criminal prosecutions was more on stopping the flow of money and less on crime control or, even less, bringing charges against all of the wrongdoers.

How did some of the big names who were pursued by criminal prosecutors fare? It is something of a mixed picture. David Paul was convicted and sentenced to eleven years in jail. Don Dixon was convicted on many counts and was eligible to serve 120 years in jail and $5.6 million in fines. But the judge sentenced him to only five years in jail, with parole eligibility in two years, and to pay $600,000 in restitution.

Keating's story is a little more complex. Keating was pursued by both state and federal authorities for securities fraud and racketeering in connection with the sale of the ACC junk bonds in Lincoln's lobby. He was convicted in state court and sentenced to ten years in jail, despite pleas for leniency from Mother Teresa. He was also convicted of federal crimes and sentenced to twelve and a half years in federal court and to pay restitution of $122 million. Keating insisted that he was broke and had no assets to pay any of the restitution. Both of Keating's convictions were overturned on appeal. The federal authorities retried him and he was convicted again, but sentenced only to four years time served. The State of California did not retry Keating, because many of the necessary witnesses had by that time died or were seriously ill.

One extensive study of criminal prosecutions flowing out of the S&L Crisis concluded that because of the sheer size and scope of the crisis and the misconduct at the heart of it, it proved difficult for the DOJ to handle much of the suspected fraud. When criminal charges were brought, conviction rates were high, around 91%. But not that many of those who engaged in arguably criminal conduct were pursued. And of those who were pursued and convicted, the sentences meted out were relatively light given the harm caused by their crimes. The average criminal sentence was thirty-six months and the median sentence was twenty-two months. Only 4% received sentences of over ten years. Also, a very small amount (<0.5%) of the restitution and fines imposed were recovered.

Consequences and Conclusions

Digging out was a long process but generally the industry stabilized. From January 1986 through 1995, 1043 institutions holding $519 billion in assets closed; the number of thrifts declined from 3234 to 1645, almost 50%. By the mid-1990s, the public and courts became more sceptical as the crisis faded. Some prior efforts to solve the problem were rebuked. Most notably, in 1996, the United States Supreme Court sided with the institutions who brought suit against the government after they were denied the use of supervisory goodwill for which they had initially entered into agreements with the FHLBB. More generally, some of that deference to the judgment of the regulators that marked the immediate post-FIRREA era disappeared.

What did the S&L Crisis cost? Forecasts varied from an estimate of $15-20 billion at the beginning of the crisis in the mid-1980s to $500 billion forecasted at the height of the crisis in the early 1990s. The ultimate cost was about $153 billion: $124 billion paid by the taxpayers, $29 billion paid by the industry. Following the economic meltdown of 2008, the regulatory reforms passed to address that crisis, among other things, did away with the OTS and the federal thrift charter, merging federal thrifts into the Office of the Comptroller of the Currency and state-chartered thrifts into the FDIC.

Lessons Learned

What lessons may be drawn from the S&L Crisis that might apply to future financial crises? Perhaps the most direct is the need not only for adequate regulation, but that the regulatory structure be independent and with sufficient resources to do what is necessary, including allowing all options for dealing with troubled institutions. Even as devoted an advocate of the free market as Adam Smith believed that financial institutions warranted different treatment. And those doing the regulating must be well-trained and sufficiently well-compensated that the lure of private practice does not hang other their heads.

But there are also deeper and less obvious lessons. One is that how a government or society responds to a crisis involves many more people than just the regulatory agencies whose primary jurisdiction involves the institutions and industry that are undergoing serious troubles. Much more than formal laws and regulations are involved in any effort to address a financial crisis. Politicians, courts, industry leaders, and the broader public play critical roles in shaping the response. The law on the books only tells you what an agency is legally authorized to do; it does not reveal what is realistically possible or acceptable as a practical matter.

Second, and related, it is much easier to regulate aggressively in bad times than in good times. All of those accounting tricks that suggested that thrifts that were actually insolvent were profitable limited what the regulators could do, as a practical matter, even when they wanted to do something. At the depths of an economic crisis, everyone – from bank executives and industry leaders to courts and the general public – will defer to the regulators, even welcome their input. But when bottom lines look flush, regulators are too easily dismissed as meddlesome types who should let the titans of industry have their way.

Finally, a critical question is how all of the players involved conduct themselves not once the most dire economic consequences are manifesting themselves, but in the run-up period before the dam breaks. In the S&L Crisis, no less than other crises, some lone voices were warning of the impending dangers, but few listened. Whether it is possible to get regulators and the other players to pay attention to those expressing doubts or warnings, and to be able to tell the difference between those who are crying wolf and those who are on to something is at the heart of preventing or minimizing future crises. Another way to express this: are the lessons learned from one crisis remembered more than a few months or years later? History suggests in some ways, but not enough to avert another crisis.

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