The S&L Debacle: What Taxpayers Should Know

By James Ring Adams

For the last year and a half, I've been doing the radio talk show circuit, which means I've spent several hundred hours on an open line with the American public, fielding calls that come in from people listening all night to talk shows. And from that experience it has been clear to me, at least since January of 1989, that the S&Ls would be the big issue in the 1990 elections – and beyond. And that the voters are mad as hell. In fact they've been mad as hell since January of 1989, and it hasn't abated. The only difference now is that Washington is aware of it.

I share this emotion. I've been angry for about five years, when to the enormous cost of my stomach lining, I started research on the topic of thrift and bank regulation. There are a lot of people to blame in Congress, in the Administration, in the state governments as well as in the bureaucracy. But I really emphatically reject the idea that this means because there is enough blame to go around, we shouldn't point a finger. I think we should point a finger as vigorously and as often as necessary. The fact that there are a lot of people to blame just means that we have to make longer lists. The list making is now going on, and I heartily encourage it. The Keating Five (Senators John Glenn, John McCain, Dennis De Concini, Alan Cranston, and Donald Riegle), Jim Wright, and Tony Coelho, are just the tip of the iceberg. The 100th Congress – the Congress before this one, in which Jim Wright was the Speaker – was probably the most corrupt in our history.

What did Congress do wrong? When we judge our Congressmen on what they did in developing the S&L debacle, I think we should distinguish between honest mistakes and dishonest mistakes.

Honest and Dishonest Mistakes. Now there are plenty of honest mistakes. I think the deregulation bills from 1979 on, even the Garn-St. Germain Bill in 1982, even the increase in deposit insurance to $100,000 per account – these are more or less honest mistakes. At the time, I shared the viewpoint that led to the honest mistakes. Even some of the OMB's highly damaging feuding with Ed Gray, the chief S&L regulator from 1983 to 1987, was, I think, from my knowledge of some of the participants, an honest mistake. But after 1985, the mistakes become more and more unforgivable, more and more influenced by campaign contributions, and, moreover, contributions from bad people. In short, the mistakes become dishonest. The epitome to me of these mistakes, and the most unforgivable because of its impact on the S&L crisis, was the passage of CEBA, the Competitive Equality Banking Act of 1987. Let's go back and look at the situation when this bill became an issue.

By 1985 it was clear that the FSLIC, the Federal Savings and Loan Insurance Corporation, the insurance fund for the S&Ls, was bankrupt. The GAO had done its annual accounting and had come up for 1985 with a deficit of $6.3 billion, which at the time was the largest deficit ever accumulated by any corporation in history (although it's small potatoes now).

James Ring Adams, author of *The Big Fix: Inside the S&L Crisis*, is a former senior editor of *Forbes* Magazine and former member of the *Wall Street Journal* editorial board.

He spoke at The Heritage Foundation on July 31, 1990.

ISSN 0272-1155. © by The Heritage Foundation.

But this was the situation when in 1985, the Administration – primarily the Home Loan Bank Board, the prime S&L regulator – really got worried and went to Congress, saying: "We have to recapitalize. We have to throw in at least another $15 billion." Now they're not even talking about taxpayers' money at this point; they're talking about going to the bond market and increasing the assessment on the industry. This money was to be off-budget, which is part of the problem.

Through 1985-86 recapitalization seemed to be treated as a necessary, even a routine measure. In fact, in 1986 it was on the consent calendar, which – those of you who are in Congress may correct me – is the place where non-controversial bills get put, those bills that are expected to pass unanimously. At that point, a lot of things were going on – both in the industry and among the regulators. Although I won't get into the details, I think it's true that the regulators on the Home Loan Bank Board were extremely worried about the condition of the industry and had succeeded to improve its supervision in spite of the efforts of others in the Administration. It had transferred its examination force to the regional Home Loan Banks, which are autonomous and off-budget, and was beginning to crack down on some of the worst actors in the industry. In short, the pressure was beginning to be felt. That is where the criminal conduct of Congress came in. When the owners of the worst thrifts began to run up against serious examinations – some for the first time in two or three years – they went to the Congressmen that they had made a point of cultivating very assiduously. These included Speaker Jim Wright, Tony Coelho, then chairman of the Democratic Congressional Campaign Committee, and a number of others – both Republicans and Democrats.

Powerful Pressure. At this point, the recapitalization of the FSLIC gave Congress an extremely powerful pressure point on the regulators, Speaker Wright held up the bill, and started raising individual cases with the Home Loan Bank Board Chairman Ed Gray. Wright, in fact, was pressuring the regulators to back off characters like Craig Hall in Dallas, Tom Gaubert of the Independent American of North Dallas, and Don Dixon of Vernon Savings and Loan, who is now finally under criminal indictment. These were people who had been significant campaign fund-raisers. Gaubert thought at one point that he was in line to be on the Democratic National Committee and was actually the DCCC finance chairman. Dixon was the person who had bought the yacht "The High Spirits" – appropriately named – moored it on the Potomac, and donated its use for congressional fundraising parties for both Democrats and Republicans. This is how the thrift owners bought their influence and this is what they used it for – to get the regulators off their backs. Not only did Congressmen make calls to regulators to protect the individual people, but Jim Wright and his Majority Whip, Tony Coelho, used CEBA – the recapitalization bill – as a means of extortion.

So Wright pulled the bill from the consent calendar at the end of 1986. Gray had a number of very intense meetings with Congressmen from Texas and with Jim Wright himself. And the bill was stalled, basically through early 1987. And this isn't a black mark only for the House of Representatives, but also the Senate. We have recently seen letters written by Senator David Pryor, the Democrat from Arkansas, who is on the Senate Ethics Committee I believe, complaining about the regulators' treatment of FirstSouth, which was the first big S&L debacle in the Southwest. In a letter of October 3, 1986, Pryor outlined complaints about the way regulators were cracking down on thrifts in Arkansas and said, "I have put a

hold on the Senate Recapitalization Bill and am anxious to receive assurances from you that you will correct the abuses that are taking place in Arkansas and other states." It is worth noting that after the Arkansas delegation, including the Representatives, made an issue of FirstSouth, the executives at that S&L became defendants in a civil fraud suit and after that were indicted on criminal charges. I find it not a total coincidence that Representatives Bill Alexander and Beryl Anthony of Arkansas were both very prominent in defending Jim Wright when his conduct became an issue in the Congress. In fact, I was told a story that I have not been able to confirm, but I'll pass it on anyway, that when FirstSouth first began to come under pressure, all the members of the Arkansas delegation wrote letters to the regulators asking them to back off. And later, when the problems of FirstSouth became more apparent, the Arkansas representatives wrote another set of letters asking for the first letters back. Apparently they got them back because the letters do not seem to be available through the Freedom of Information Act. In fact, the letter that I quoted from came out only this May in one of Henry Gonzalez's House Banking Committee hearings in Dallas on bank fraud, and it came up rather fortuitously.

Increased Interference. But if the Democrats held up funding for the bankrupt FSLIC, Republicans did their own amount of damage with another issue, forbearance. These provisions were the brainchild of Texas Representative Steve Bartlett and Texas Senator Phil Gramm. Forbearance has a more technical character and I won't go into the details, but these provisions deserve condemnation as another attempt to hamper the regulators; in effect, to make the regulators give a break to the S&Ls that manifestly needed to be disciplined. Just as it was clear that supervision had been devastated by the lack of funds and political interference, the CEBA bill denied the regulators money and increased the interference.

Let's look at what this cost. I mentioned at the time that the audited losses in the FSLIC were $7.9 billion. The true loss may have been something like $30 billion. The Administration a year later was asking for only $15 billion, which probably was a serious underestimation at the time. Yet Congress, at the behest of the United States League for Savings Institutions, was willing to authorize only $5 billion. And its reason – this was expressly stated in the floor debate – was to prevent the FSLIC from using the money to close institutions that needed to be closed, institutions that were owned by large contributors. At the time, these institutions were losing $20 million a day. Yet, for reasons we can go into later, they were attracting deposits at a higher rate than the healthy Savings and Loans. If we think about this for a minute, maybe we can see why the cost of the disaster is so staggering. It is something that accumulates from point one day by day, and when we add the cost of raising the money to pay for it, which means the interest costs, we double and triple the amount we already have lost. That is why I point to the failure of Congress to grant the Administration's request for recapitalization, the vote on the CEBA bill, as a guide, and maybe the best guide as to whether you want to reelect your incumbent. On the key vote in the House to grant the full $15 billion, only 153 members voted yes.

But why did things go wrong? The disaster was more than simply a matter of personalities. It was more than just Jim Wright or Tony Coelho or Phil Gramm. Or Don Regan in the White House. It resulted from a corrupting structure and corrupt attitudes.

Corrupting Structure. First the structure. You probably heard some reference to the issue of the *Stanford Law Review* that produced the high-end estimate of the losses: $1.4 tril-

lion. It also had a very astute analysis of the S&L disaster. The article I would recommend is by Joseph Grundfest, who was on the SEC until recently. He sees an environment for this kind of disaster that could be replicated by any special interest that meets four conditions: one, if it has a wide geographic base, like the S&Ls, with a prominent figure in every town; two, if it is non-ideological, like the S&Ls, devoted to an apple pie activity such as making home-loan mortgages (up until now, the S&Ls have been associated in popular culture with Jimmy Stewart and "It's a Wonderful Life"); three, if it is an industry that is willing to lobby Congress vigorously and, in fact ruthlessly; four, if it is asking for money that won't show up on the budget. And remember that the FSLIC is an off-budget agency, and that the whole cost of the S&Ls, until recently, has been off-budget.

With these four factors, you basically can walk into Congress and get what you want. Or as Grundfest said, "An industry that garners the support of a geographically dispersed, ideologically neutral, monied contributions constituency that is not asking for a direct hand-out, can cut through Congress like a hot knife through butter." The S&Ls are not the only industry that fits these conditions.

Campaign Contributions. Beyond that lies the power of campaign contributions. The S&Ls were a major source of fundraising. In fact, Tony Coelho at some point justified his use of the S&L pressure point as a counter to the Republican power in fundraising. He came to rely on the group of Texas thrifts, the "high flyers," people who are now under indictment or on their way to jail. These were people who used their depositors' money for classic cars, tours of Europe, four-star restaurants in France, and beach houses in California. Some actually staged sexual orgies to corrupt and bind their customers in what was basically a criminal conspiracy. These people were good for several hundred thousand dollars at a pop. In fact, this group formed the PAC that was instrumental in the special East Texas congressional election in 1985. Republican strategists wanted to elect a Republican in what had been Sam Rayburn's congressional district. That victory, they thought, would consolidate their gains in the South, but they were defeated by relatively few votes. This victory for the Democrats helped seal Jim Wright's succession to the speakership. This victory was practically procured by the money of the Texas "high flyers," working through the East Texas First PAC, which was a virtual overlay with the thrifts that later went bankrupt in the most spectacular disasters.

The power of campaign contributions is intensified even more by the fact that in the last few years, with enough money and appropriate technology, any Member of Congress who wants to be re-elected can be.

What is the technology that does this? When I was on the talk show circuit and relied on television to plug my book, I was a little carefree about saying this. But I think we should bring it up now. What we're talking about is really television time — political commercials. Contributions procure the high-priced professionals who both have access to the airwaves and produce the commercials. This technology is responsible both for the surge in the cost of campaigns and the debasement of their contents. The result is a "period of stagnation," to borrow a phrase from our Soviet friends, that in some respects — and I am mindful of the audience here — is compounded by what Michael Malbin calls the legocracy, the perpetual staff on Capitol Hill. And when we talk about the Members of Congress I think we should also talk about their staffs, because some of their staff members have been even more cor-

rupt than the Congressmen. The proposal to set up a special prosecutor to investigate Congress should be broadened to include the conduct of certain staff members as well.

Corrupting Attitudes. That's the structure. Now let's talk about attitudes. I think the S&L disaster results from the degeneration of standards of conduct in Congress. This corruption is not only measurable, it is blatant – dramatically blatant – when Congress comes to balancing favors for large contributors on the one hand against the integrity of regulation and the public interest on the other hand. I think a dramatic example, the *locus classicus* of this degeneration, comes from the pages of two documents that were produced during the trial of Speaker Wright. The currently prevailing attitude appears in the House Ethics Committee report on Speaker Wright, which condemned him on relatively minor infringements and excluded the Savings and Loan extortion entirely. The Ethics Committee refused to condemn Wright's wire-pulling for the Texas group of political donors, calling it "not inconsistent with Congressional standards." Charging Wright with wrongdoing on these counts, it said, would jeopardize, "the ability of members effectively to represent persons and organizations having concern with the activities of executive agencies." Which, as you know, translates into lobbying for big contributors.

The older, opposite point of view was urged strongly by special counsel Richard Phelan in his report to the Ethics Committee, which was accepted only in part. In his report on Wright, Phelan twice quoted from the book *Ethics in Government* by former Senator Paul Douglas. "A legislator should not immediately conclude that the constituent is always right and the administrator is always wrong, but as far as possible should try to find out the merits of each case and only make such representations as the situation permits." In other words, a Congressman is supposed to take a detached view and see if the constituent in his complaint is selling him a bill of goods.

Constituent Services. What does the Douglas standard have that the House Ethics Committee refuses to acknowledge? The answer is an old-fashioned quality – statesmanship. Douglas insists that Members keep an eye on the public good. Senator Douglas, one of the last truly distinguished Members of the Senate, asks that the Congressman turn down his contributors when they might be wrong. And if you think Congress hasn't forgotten that point, just remember what we heard *ad nauseam* from Jim Wright and his supporters during the debate. Wright said, "I was just doing what any Congressman would do for a constituent."

I think there's more even beyond that story.

Going back to the *Stanford Law Review* that I cited, one of its articles is a political science analysis of the debacle which states that "Congressional behavior in this case, should be seen as fairly routine politics rather than an outrageous deviation." In other words, in the prism of academic political science, the conduct that produced our $500 billion or trillion dollar disaster is routine politics. And I think that's because not only Congress but also political science has forgotten the element of statesmanship. Political science not only forgets it but despises it as a delusion of an earlier era. By analyzing politicians without making value judgments, political science has played an enormous role in corrupting politics. Maybe the academics I'm talking about didn't influence the first generation of elected officials that they studied, but these professors educated the current crop of Congressmen, and even more so their staffs.

Talking Long For Good. We could go into that last point as deeply as you want, but for now I'm concerned with the reaction of the voters. Getting back to the original point, when the taxpayer receives a bill for two thousand dollars a head, four thousand or ten thousand just to cover a dead loss with no benefit whatever (he is not going to get anything with this money), he is not going to think of this debacle as fairly routine politics. In fact, when the voters come to judge Congress on the Savings and Loan issue, the corrupt dependence on political contributions, the collapse of statesmanlike standards, and the overall period of political stagnation, they may want to use words that have a long history in Western Parliamentary government. These words helped drive Neville Chamberlain from office as British Prime Minister in 1940, but they were first spoken by Oliver Cromwell to the Long Parliament in the 1630s. The voters may say, as Cromwell said before them, "You have sat too long here for any good you have been doing. Depart I say, and let us have done with you. In the name of God, go."

S&Ls : From Inquisition to Reform

By Warren T. Brookes

S&Ls. Gosh, I hope we're getting tired of that subject, but it is something that is going to be with us for awhile, I'm afraid. It would be nice if we were to see it as what it really is – which is a very expensive $150 billion lesson. The $500 billion and trillion numbers you are hearing are a result of compounding the interest, and I could play that game with you all day by saying this year's budget is not a $165 billion budget deficit, it is really a trillion dollar budget deficit. Let's get away from this trillion dollar business, it's a $150 billion problem, thereabouts. Big enough. Bigger than a bread box, that's for sure. It's a very expensive lesson in what happens when government interferes with market processes.

We keep getting these lessons, and we keep ignoring them. The sad thing is that we're getting another lesson ignored even as we speak. I was at a meeting today where Treasury Secretary Nicholas Brady was being quizzed about a lot of things, and about half the questions he got from the press were, "What are you going to do about price gouging on oil and gasoline?" His response was to the effect, "We're going to get those guys for price gouging on oil." Now, apparently Mr. Brady was not around in the '70s. As I recall, we "got" those suckers, and we all wound up in gasoline lines in 1979 and 1980 because we wiped out the signals from the marketplace. We, in effect, said, "American companies could not gouge." We had price controls, courtesy of Richard Nixon, and because of the fear that they would gouge we never took the price controls off.

I did a little calculation as to what that cost us, and there is a very simple way of doing that calculation. In 1981 the first thing Ronald Reagan did in office was to deregulate the price of oil. Before that everyone had thought that with deregulation the price of gas was going to go to $2 a gallon and the price of oil to $50 a barrel. A lot of foolish Texans had gone out and bet on that – with our money. Those of us who had been watching this thing for years had been telling those guys that the price was probably going to go down and not up. They didn't believe us. They said "get us deregulation." They were happy to see deregulation – until it arrived. The price signals started getting set, and in came the supply; the market began to adjust, and guess what? We went from $32 to $15 oil within three years. I reckon, in very back-of-envelope economics, this amounts to roughly $15 a barrel that we had been overpaying by having price controls on oil. Figuring from 1975 forward, it adds up to about $450 billion we overpaid on oil. We're not hearing about the $450 billion oil scandal, but that's what we overpaid by having price controls. That's literally true, because the price of oil never should have gone above $15.

Distrust of the Market. Now I use that as a little illustration, only to tell you that the mistakes we've been making on the S&Ls are not that big compared to some of the other ones we've been making. We keep making these mistakes because we keep arguing that somehow the market doesn't work. People say it works in a lot of places, but it doesn't work here. Eastern Europe – that is because of bad management. It's not. In Poland a year ago people were standing in line. Now there's food everywhere. All the stores are full. Where did it all come from? Not from a management change but from a market change. If we had

---

Warren T. Brookes is a nationally syndicated columnist and editorial writer for the *Detroit News*.

He spoke at The Heritage Foundation on August 8, 1990.

ISSN 0272-1155. ©1990 by The Heritage Foundation

a market system in everything, it would work better because the market works better in everything. There is no exception, and it happens to be true of banking. But for some reason, we don't seem to believe that you can trust the market in banking. So we created the system we now have, which caused the mess we now have. It was created because we didn't trust the market to behave.

There are a couple of numbers I think you ought to know about. In 1935, when we "rescued" the financial institutions of this country with Glass-Steagall and McFadden-Douglas and a host of other regulations and deposit insurance (which is the real culprit), we had about 13.5 percent capital in the total financial system of this country (banks mainly). Today, we have about 5-6 percent capital. Look how much better off we are with all that regulation. $150 billion bailout in S&Ls; the banks are in almost as bad shape; and we now have this marvelous system, bankrupt deposit insurance, we created to rescue the banking business to save us from those dreadful "predatory bankers" and save us from ever having a run again. These are all things we invented in the 1930s because we did not believe the financial markets would work. I have to tell you that an awful lot of conservatives are among those people who think, "Most markets work, but financial markets are not very reliable." I had a very prominent economist — who shall be nameless, but you would recognize him on the television — who said when I suggested the Federal Reserve should operate a policy based on reading the market signals, "You can't trust financial market signals." This was said by a free market, supply-side economist.

Social Program. Now I happen to believe if markets work in everything else, why won't they work in financial services? They should and they will. The problem is that we have not allowed them to. We have created a system which is almost totally government-constructed. We have to understand the S&L crisis from that perspective. We created the S&Ls as a government-sponsored enterprise. A lot of people forget that we had an idea back in the '30s that we needed to create an institution that would borrow from consumers — small savers — and lend strictly to home buyers and home builders. It was constructed as a social program, a government-constructed concept. A person could get a charter if he had the right occupation in a town, and with the right political connections he could create an S&L and get a charter. It wasn't hard. And, the idea worked beautifully for nearly 30 years. One of the things that is amazing about the S&Ls is how long they did work.

Part of the reason was that the banks never realized what a good thing property lending was, and it took them a long time to figure it out. For many years the S&Ls were borrowing at very cheap rates — we had low interest rates — from passbook savers, lending long to a housing boom, and going out on the golf course on Wednesday. That's how one made money in the S&L business, and a lot of people did extremely well.

But it was an idea that depended on a construct that began to fail the minute we began to deregulate financial markets and the minute we left the gold standard — courtesy of Richard Nixon. The minute we basically turned the financial system loose from its moorings, the S&L concept began to fail and has been brain dead — market dead — since early 1974. There has been no basis to stay in the S&L business since that time, because interest rates and inflation began to take off. We had an S&L industry that was operating for its own safety upon a premise that it could not borrow at more than 5 1/2 percent passbook interest rates, and it was lending at 6 to 8 percent.

The golf course trip was suddenly threatened because suddenly the S&Ls couldn't get or keep the money at 5 1/2 percent; they couldn't keep their deposit money from flowing into money-market funds and going into other places because the interest rates were going up higher. Meanwhile their loan portfolio was still at 7 to 8 percent, and soon they were in deep trouble. The current situation really got started, I would argue, if you were looking for culprits or looking for people to blame, with Richard Nixon. There's a good place to start. Richard Nixon committed the unpardonable sin of closing the Gold Window at the Federal Reserve, in 1971, and ended the IMF agreement that contained the final tenuous link between the dollar and gold. From that time on we had the floating dollar, floating exchange rates, floating paper. The inevitable result of that (everybody could have easily predicted), was high interest rates and high inflation.

Concept Voided. Once that happened, the opportunity to borrow short at very low rates and lend long at moderate rates and make a nice profit on the spread was gone. Forever. It was just not feasible. If anybody told you had to borrow short and you had to lend long, which is what the S&Ls are designed to do, you would know the approach couldn't work in a freely moving financial marketplace. Bankers have to be able to adjust what they borrow at and adjust their loan rates. So the S&L concept was voided at the moment Richard Nixon closed the Gold Window.

It took a while to show up, but by 1979, people began to take their money out of S&Ls. For very good reasons. They took their money out of insured deposits and put them in uninsured money-market funds. Why? Because the markets funds were paying 10 to 12 percent, and the S&Ls were paying 5 1/2 percent. The money was just pouring out the front door. Meanwhile, their loan portfolio was locked in at fixed mortgages of 7 or 8 percent, not producing enough money, to allow them to go out and borrow on their own – get more capital on their own. So the industry was essentially dying in 1979 and 1980.

Compounded by Congress. Now, that was a good time for Congress to have shot it. It would have been the humane thing to do for all of us. But it didn't. It did what it always did: compounded the problem. It "reformed" the system in 1980 under Jimmy Carter. We lifted the rate of passbooks – I'm oversimplifying this – we allowed them to do more venturesome lending, although not a lot, and we also committed the unpardonable sin of raising the deposit insurance coverage from $40,000 to $100,000 per account. All of that was contained in a thing called the Depository Institutions and Monetary Control Act of 1980 – one of Jimmy Carter's deregulation fronts. Everybody blames deregulation on Ronald Reagan; but most of it was done under Jimmy Carter. Incidentally, most of it was good; most of it was very good. This was one of those places where it wasn't so good because it wasn't really deregulation. It was simply, in effect, delimiting the access to our pocketbooks. It said to the S&Ls that they could go out and offer as much interest as they wanted, and loan more widely.

Let's understand something about the whole premise of banking. It does operate on very low levels of capital. There must be enough capital in there, however, at least to require that before you pay off the depositors there ought to be some pain to stockholders. With deposit insurance we have steadily reduced the pain; we took the pain away. The S&L pain used to be 3, 4, 5, 6 percent. But in the 1980s to keep them open, we steadily diluted the capital standards, diluted the pain, and raised the coverage. We went from covering 70 to 80 percent of deposit to covering effectively 100 percent. We reduced the deductible from capital

from 3 to 5 percent down to 3, then 2, and then 1, and pretty soon it was zilch. In other words, taxpayers became responsible through a whole series of actions caused by dumping the gold standard, and turning loose inflation. Jimmy Carter brought in Bill Miller to the Fed, and the Federal Reserve was printing money to beat the band, and ratifying the oil price increases of 1979-1980, caused by government regulation. We had a mindless assault on economic sanity in the 1970s and 1980s culminating in the Depository Institutions and Monetary Control Act of 1980 in which we said, "Hey, we're going to save you because you can now go out and lend in ways you never have lent before and you can borrow at higher rates. You can offer 8, 9, 10 percent – as a matter of fact, 10, 12, 13 percent, to get your money." All this was said to an industry which was at that moment largely insolvent, mostly bankrupt. I'll tell how bankrupt they were.

Designed to Benefit Politicians. When Ronald Reagan took office in January 1981, 3,300 out of 3,800 S&Ls lost money that year. In 1982 the combined tangible net capital of this industry was $4 billion. They have $15 to $20 billion now. It's not enough, they ought to have $40 to $50 billion; but at that moment they had $4 billion. There was only one honest solution at that point: shoot the industry or hand it over to Sears Roebuck, or Ford Motor Company, or General Motors GMAC. There's more money in local auto dealerships in GMAC capital. The trouble is, legally we can't do that. American Express would love to have had 300 or 400 S&Ls around the country; so would Sears Roebuck. One in every store, have one-stop lending. But you can't do that under the law. Why do we have a banking system the way it is today? Because we have got a bunch of laws supposedly to protect us from these terrible gouging bankers, the possibility of concentration of power and wealth and the great malefactors of great wealth. We said in effect we wanted little banks, and as many banks as possible. We couldn't interstate, we couldn't branch, we couldn't combine; we in effect created a system which was beautiful politically. It gave every Congressman dozens of bankers who were dependent on him. It was designed for politicians' benefit, not for ours.

If you go to England, you will see half a dozen banks around the country. Total. Five or six banks. They have branches everywhere. Go to a little town and you find a Lloyds or Barclays, or whatever the bank is. The major banks in England, about five or six of them, have branches everywhere. We don't have that. Citicorp can't branch in Boston, it can't branch in New Jersey. But we're going to change that; the states are beginning to allow it. But the point is that we created a system of thousands of separate banks, all undercapitalized, all very vulnerable to local regional economic downturns. They had no strength, and were all politically beholden to a system that was premised on insuring everybody at the same price irrespective of the risk taking. It would be impossible to dream up a greater nightmare than what we created in the U.S. banking system.

Real Market Evaluation. So it's not just the S&Ls. It's the banks. We have a banking system that is just as bad off, when you get right down to it, as the S&Ls. We're headed for just as big a crisis in banking. I hate to tell you this, but we must do something quick about fixing the system. My column today is dealing with the fact that there are people, fortunately in Congress – mostly Democrats – who are now worried enough to try to change the deposit insurance system and the banking system so that we can begin to get capital back. Because if we don't get capital flowing in, we are not protected. And we have got to go back to the system where the market has a chance to work. We need risk-based, real market evaluation on whether a bank or an S&L is a good bank or a good S&L, and where we as consumers

have an incentive to deposit in a good bank and not a bad one. We need to pick the bank that doesn't give us toasters or cars or anything else just to get our hundred-dollar accounts; to pick a bank that is really solid one, that we can depend upon when the going gets rough.

Restoring Some Pain. The only way we are going to do that is to get away from insuring every deposit dollar. We have to restore some pain out there. Just as we have to have people who lose money because they bought aluminum siding from a guy they shouldn't have trusted, we have to have people lose money from a bank they shouldn't have trusted. Maybe we shouldn't have a lot of pain, but some pain.

And fortunately there are organizations in this town like Competitive Enterprise Institute, and Heritage, and Brookings that are arguing this case, and it is slowly getting through. They're slowly getting the Congress to wake up: "You're going to have to do something to put a little pain back in the system." Maybe it involves something as simple as saying, "Look, we're only going to insure 80 percent of your account you know. You're going to lose the first 20 percent, so you'd better be careful." If we said, "Look, we'll only give you 80 percent of your account," you'd go to a bank would cover the other 20, right? With its own insurance. And the good banks would be able to buy such insurance quite cheaply, and they would be able to say to you, "Hey, we can give you a better rate than the other guy because we can give you the insurance, because we're a lower risk." And then the market would begin to work, and the guys who couldn't get the insurance for that other 20 percent would fall by the wayside. We would create an incentive system that works the way the market works, a system that says good banks should survive but bad banks should go out of business.

Right now we've got a system which says good banks and bad banks survive no matter what. So we might as well run a bad bank, and we might as well put our money in a bad bank because they pay higher interest rates. We've been doing that. Where do you think all these losses came from?

Too Much Money. A little secret. Most of it came because people like Merrill Lynch discovered that they could take big money and bundle it in $100,000 units and go to the Podunk S&L in Podunk, Arkansas, and pour $10 million into that bank at high rates fully insured. No wonder these little banks were out investing in windmill farms and junk bonds and anything they could find. They couldn't find enough places to put their money. Guys were opening up banks, literally opening up banks on telephones in California and raising money from around the country. Bundles of money – brokered money – from places like PaineWebber and Merrill Lynch and all these different brokers, flowed in. Because S&Ls couldn't hold on to it, they had to put it out in high return loans. And that's why you suddenly had a lot of money flowing out of S&Ls, not into normal home mortgage lending because it wasn't profitable enough, but into risky things you'd get 10, 12, 15 percent on.

We took an industry, in effect, which had been designed to do a certain thing and suddenly said, hey, you can act like a bank. But there was no way they could. They didn't have the experience, they didn't have the ability, they didn't have anything going. The recipe for the disaster was put together finally in 1980. I believe the legislation passed in March of 1980, which was the spring of Jimmy Carter's discontent.

We have a hard time blaming Jimmy Carter – no, we don't blame Jimmy Carter, but we could blame a lot of people. We could blame the people who wrote the FDIC and the

original FSLIC laws. The S&L crisis has been a disaster waiting to happen for a long time, and it has happened. Now the problem is, are we going to learn from it? Your guess is a good as mine. I don't have a lot of hope in this town because I am afraid that we are going to be so busy in the next two to three years just going after Neil Bush and the Keating Five and whatever, that we're going basically to miss the opportunity to put the U.S. banking system back on track.

Fortunately, there's a guy named John LaFalce who is head of the International Competitiveness Task Force for the House Banking Committee. He's a Congressman from upstate New York who occupies a district that used to be run by Bill Miller, the guy that ran with Barry Goldwater. (And Goldwater still speaks highly of Congressman Miller.) LaFalce is raising the question: How are we going to get our financial industry back on track and get enough capital in it? And the only answer is that we've got to get people like American Express and Sears Roebuck and General Motors and all these people that have capital to put their capital into the financial service industry.

Appropriate Regulation. We have to let Citicorp branch, and we have to let the big banks go out and buy up smaller banks, expand, and go interstate. And we have to let them get involved in doing a lot of other things, like handling securities transactions, doing insurance, and providing a whole bunch of financial services. We ought to let them do this within appropriate safeguards. I'm not arguing for hands off. We're going to have to have regulatory controls, but we ought to be able to emulate the relatively hands-off regulatory approaches of the other nations because the other nations do not do the kind of regulatory hammering that we are now seeing. What we are seeing now is a regulatory credit crunch.

We see a lot of banks and S&Ls, good ones, in a flight to quality. It started when the Administration decided to bail out the S&Ls entirely on the premise of raising capital standards. They didn't even try to deal with the deposit insurance. They didn't even try to deal with branch banking. They didn't try to deal with any of the issues that you or I know are essential. All they say is that we're going to do a bailout. Got to get a bailout. Got to get it through. And the way to do it is to toughen up the capital standards.

When I asked Dick Breen a year and a half ago, I said, "But, Dick, where are they going to get the capital? Where is a little S&L, a mutual, going to find the necessary 3 or 4 percent capital when they've only got 1 percent now, and they're just barely hanging on by their thumbs. Where are they going to get the capital?" I said, "Would you invest in an S&L at this point?"

He answered, "Well, that's not a fair question."

I said, "Yes, it is a fair question. Who is going to invest in these people? Who is going to give them the capital if they are prevented from earning, from getting into lots of different businesses? You're going to say, 'Hey, we're going to make you put 70 percent of your money into home mortgages. Hey, you can only make a certain amount of home mortgages.' You're going to invest in that?"

Not Enough Capital. There's lots better ways to move your money. Capital is not going to flow into this industry. In order to meet the standards that the Bush bill called for they need $40 to $50 billion dollars in capital. They don't have it. The industry's got less than $20 billion. They can't get another $30 billion. Where are they going to get it from?

The answer is nowhere. I'll tell you how bad the situation is. I wrote a series a year ago in June on the whole Keating Five episode. I wrote not to point out the scandal that was involved but to show the fallacy of the Bush bailout, because guess what? When they took over Lincoln on April 2, 1989, Charlie Keating's system had more capital in it under the accounting rules than was required in the Bush bill. More capital. Charlie Keating was fully capitalized. When they took Lincoln over, in the terms of this big bill that was passed in September, he was GAAP solvent. I repeat that, Charlie Keating was GAAP solvent when they took him over. He had 2 1/2 percent net tangible capital, I think the standard is 1 1/2 in the bill. He was well over the limit. Now, they were right in taking him over because if you accounted the actual value of his real estate assets on a market basis, he didn't have that capital. The legislation only requires GAAP, that's Generally Accepted Accounting Principles, which allows every asset, every loan on the books to be at book value.

So you take book value – Charlie Keating has good book value loans. His GAAP worth is such and his capital is such and he met the standard. If you mark those book assets at market value, hey, that capital doesn't exist. But the bill didn't require accounting based on market value. I ask the Administration why? Why don't you at least require market value accounting. They answer, "Oh, we'd put the whole industry out of business." Right.

Now there was a solution waiting to happen, but it never happened. We could have said instead of doing that, we were going to reduce the taxpayer exposure. That's what we should have done. We should have taken the taxpayers' exposure back 10 to 20 percent and then let the capital standards stay where they were. Because what we wanted to do is to reduce exposure. Instead of having a 3 percent capital deductible we would have a 20 percent deductible. Raise the deductible from the standpoint of the taxpayers.

Sharing Losses. So then we could have losses, Losses shared by depositors and owners, but losses at least not fully backed by the taxpayers. I want to ask you to think about something: We have constructed the system today in such a way that in effect the deposit insurance covers so much of the system that we cannot afford to let any bank fail, big banks especially. We have the "too-big-to-fail" situation. You've heard about that. The reason we have banks "too big to fail" is because it's cheaper not to let them fail than to let them fail. I mean the deposit insurance, the FDIC, says, "We're covering over 80 percent already; we can't afford to let them fail." So the big banks basically don't fail. And when you have big banks not failing, small banks don't either. That is what's happening. That means that in effect we are insuring every loan.

I want to remind you of that. We are not insuring deposits; we are really insuring every loan that every banker banks. Think about that. We are now, as taxpayers, effectively insuring every loan that every banker and every loan officer in this country makes. Do you hear that? Do you honestly believe that all bankers and thrift operators are infallible? Because that's the premise. Because the capital deductible is so small – the capital is what, 1, 2 percent – we effectively insure every loan. We've got to reduce the insurance of those loans. We've got to get back to 80 percent. Let's insure only 80 percent of every loan. That's bad enough. It should be 50 or 40 percent, or even nothing.

The point is we've got to do what is politically possible. We've got to reduce the exposure of the taxpayers. Because, as taxpayers, we are on the hook now for massive – what two and a half, three trillion dollars of insurance. There isn't that kind of money in the system, in the

whole economy to deal with this. And that's where we are today. So we're going to get Neil Bush, we're going to the Keating Five. Forget it. We've got to protect ourselves. We've got to get the politicians to wake up and realize that right now as taxpayers we are on the hook for a system that is being destroyed by our backing insurance.

Fault of Politicians. Because by backing the system as taxpayers we force intense regulation. We don't allow deregulation. We don't allow those banks to compete. We are creating a competitive nightmare. And it is happening even as we speak. Ten years ago we had eight or ten banks in the world's top twenty. Now we have one in the top thirty in the world. We are being destroyed by this insane system. And the system is not being killed by crooks. There are crooks, of course, but that's insignificant. Sadly, what you're going to get is the politicians and the *Washington Post* concentrating on the crooks, and we're going to let slip by all this opportunity to learn from this lesson and not to repeat the mistakes. We're going to prosecute a bunch of crooks. We're going to run stories about prosecuting crooks and they don't amount to what — 3 to 5 percent of the total at most. Ninety-five percent of it was the fault of the politicians, and the politicians don't want you to know that. That's my story.