Real thrifts story—the deregulation disaster—has yet to be told

by Harley Schlanger

Inside Job: The Looting of America's Savings and Loans
by Stephen Pizzo, Mary Fricker, and Paul Muolo
McGraw-Hill, New York, 1989
443 pages, hardbound, $19.95

Other People's Money: The Inside Story of the S&L Mess
by Paul Zane Pilzer with Robert Deitz
Simon and Schuster, New York, 1989
269 pages, hardbound, $18.95

In a late-January series of announcements surprising no one, spokesmen for the Treasury Department admitted that it would be necessary for the government to add at least $50 billion more to the budget for the bailout of the nation's savings and loans institutions. Deputy Secretary John E. Robson told the House Banking Committee that the initial installment of $50 billion "will prove inadequate" to last until August 1992, despite projections made last year when Congress passed President Bush's bailout bill.

In fact, most analysts concluded months ago that the estimates made when the bill was presented were ridiculously low. Since August 1989, when the Resolution Trust Corp. (RTC) was created to handle failed S&Ls, 342 have been taken over. Thus far, the RTC has been able to dispose of only 40 of these. At least 200 more thrifts are presently on the watch list, with more expected to be added when a new list comes out in February. Furthermore, the RTC has had little success raising funds from sale of foreclosed properties, which was supposed to bring in revenues to finance the new closings.

When the President's men were selling the "Bush plan" to Congress, foremost in their method was the Washington tradition of damage control: Under no circumstances should the real cost of the S&L bailout—now estimated to be at $300 billion and climbing—be made known. If it were, it would undermine the credibility of the "Great Recovery" and make a mockery of the claims that the Reagan-Bush administrations have made progress in "reducing the deficit" by hitting the Gramm-Rudman targets. Thus, they deliberately underestimated the costs, and put as much of the expenditures as possible "off-budget."

To distract attention from this sleight-of-hand, a total of $50 million was allocated to the Justice Department to add to the existing task force on "S&L fraud," whose actions have been characterized as reminiscent of the Gestapo by those under scrutiny, as well as by some congressmen who opposed the measure. The assignment of the task force was to make a credible case that the cause of the S&L crisis is fraud and corruption, and that this is why the bailout is necessary.

The real cause of the S&L crisis

What President Bush fears most is exposure of the failure of the economic policies of the Reagan-Bush years. These policies, which have been a continuation of those pushed by the Carter administration, were designed to speed up the restructuring of the U.S. economy from one whose wealth is based on constant improvements in industrial and agricultural productivity, to that of a "post-industrial," or "service" economy.

To achieve constant technological innovation, which is the key to increasing the rate at which the productivity of a nation's industrial and agricultural producers increases, a nation must have cheap, long-term credit accessible to those entrepreneurs who will invest in the research and development necessary for the next generation of innovations. It was the adoption of this approach by President Franklin D. Roosevelt in 1939-40, when he mandated the Federal Reserve to provide cheap credit through a regulated banking system to gear up the goods-production necessary to fight a war, that pulled the U.S. out of the last Great Depression.

From the end of World War II through the early 1960s, our economy progressed under a regime of regulated banking and low, stable interest rates. It was acknowledged that this policy led to further increases in labor productivity, through technological advances which in turn generated a surplus allowing for improvements in the standard of living, through better health care, more advanced education, and home ownership. This approach was cast aside after the assassination of President Kennedy, to be replaced by an anti-technology, "ecological" bias. The cutback in funds to NASA was the harbinger of things to come.

"Deindustrialization" was pushed rapidly ahead during the Carter years. It was Carter's appointment of Paul Volcker in October 1979 as chairman of the Federal Reserve Board that signaled the beginning of the end of the postwar era. Under Volcker, interest rates were raised to more than 20%. This triggered a flow of deposits out of the S&Ls, since depositors could get higher rates by investing in various types of financial paper than from traditional passbook savings accounts. The S&Ls were limited in what they could give to savers, as their income derived largely from payments on low-interest mortgages.

As the outflow of funds threatened the whole thrift sector, a fatal decision was made, to "deregulate" the S&Ls. Deregulation was a critical weapon in the promotion of post-industrial economics. The trucking industry had been deregulated, then airlines. Among those most actively pushing deregulation were financial institutions such as Merrill Lynch, whose chairman Don Regan had been instrumental in deregulating financial markets with the creation of Cash Management Accounts in 1976.

In 1980, and again in 1982 with the passage of the Garn-St Germain Depository Institutions Act, the S&Ls were deregulated. Instead of serving as institutions to finance home building and ownership, they were thrust into competition with commercial banks and Wall Street investment firms. As the cost of funds rose for the S&Ls, they could stay in business only by engaging in the most speculative practices, such as selling high-interest jumbo Certificates of Deposits to deposit brokers, then investing the funds in high-risk commercial real estate ventures and junk bonds. When these investments went bad, beginning in the southwest, hundreds of S&Ls became insolvent, the victims of the shift to a post-industrial, deregulated economy.

The 'sizzle' behind the DoJ's fraud squad

There is no doubt that, in the climate created by these policies, fraud and corruption did occur. Suddenly, there were no restrictions on lending and a seemingly endless supply of deposit brokers offering ready cash to any thrift. S&L directors, the majority of whom were honest, were forced into increasingly risky ventures if they wished to "stay in the hunt" for funds. In fact, they were encouraged by government policy to do this. Those who were less honest soon realized an additional bonus: In the relaxed regulatory environment, and with deposit insurance now covering up to $100,000 per account (up from $40,000), there was nothing to lose: If an investment went sour, FSLIC (or later, the taxpayer) would pick up the tab.

Several books have been released recently, each claiming to be the "true inside story of the S&L crisis." These have provided a public relations boost for the DoJ's fraud squad, claiming to prove that the S&L debacle is due to fraud. Two of these, *Inside Job* and *Other People's Money*, are characteristic of the genre.

While thoroughly documenting several instances of probable fraud (most revolving around the networks associated with Louisiana businessman Herman K. Beebe, including the infamous Donald Dixon of Vernon S&L of Texas), these books "miss the forest for the trees." Without Volcker and deregulation and the shift to post-industrial society these policies furthered, there would have been limited possibility for fraud. This is not to say that they ignore the role of Volcker's interest rates and deregulation in creating the crisis. Pilzer, for example, says that Volcker's policy "was the equivalent of trying to extinguish a kitchen blaze with gasoline. It touched off an inflationary interest rate firestorm that almost destroyed the thrift industry overnight." However, since the authors of both books support deregulation, they fail to accurately present the cause and effect between deregulation, high interest rates, and fraud.

Pizzo, et al. present this hypothesis in the introduction: "The ink wasn't dry on the Garn-St Germain legislation . . . before high-stakes investors, swindlers and mobsters lined up to loot S&Ls. They immediately seized the opportunity created by careless deregulation of thrifts and gambled, stole, and embezzled away billions in an orgy of greed and excess." These authors attempt to prove that S&Ls collapsed because they were "victims of incompetent management, poor or nonexistent supervision, insider abuse and, most important, outright fraud."

The essence of these studies was summed up by Thomas Gaubert, a former S&L owner and longtime target of the DoJ, who gave a Texas reporter his views of this type of journalism, which focuses only on the corruption and "high living" of the alleged S&L crooks: "The story is the yachts, the airplanes—that's what you guys call sizzle, that's what you guys say sells your magazines, and you're all a bunch of whores."

There are, buried within the details of the "sizzle," some useful insights in these books. Pilzer has an interesting chapter on S&L involvement in junk bond purchases, particularly by California S&Ls linked to junk bond king Michael Milken, in which he presents an ominous warning: "The California debacle is still unfolding, its ultimate cost still beyond reckoning. All it will take is a new round of sharp interest-rate swings and the now-moribund S&Ls that played the California game will generate additional billions in losses." Also, his chapter on the Southwest Plan of former FSLIC director Danny Wall, in which the assets of S&Ls were practically handed to Wall Street speculators, is on target.

One wishes Pizzo, Fricker, and Muolo had investigated more thoroughly what appears as an afterthought in their book, that the CIA was using banks to launder drug money and get loans that went to finance the Contras. They say that they "didn't have time" to probe this, but they "want to go on record as saying that we finally came to believe something involving the CIA and Contras was going on at thrifts during the 1980s."

These insights aside, the real story of the thrift crisis is not yet written. And the taxpayers will continue to pay the price.