



This is to certify that the
dissertation entitled

HEADS THE S&LS WIN, TAILS THE TAXPAYERS LOSE:
THE POLITICS BEHIND REGULATION AND
DEREGULATION OF THE SAVINGS AND LOAN INDUSTRY

presented by

JILL S. HUERTA

has been accepted towards fulfillment
of the requirements for the

Doctoral degree in History

Reely Steute-Hasted
Major Professor's Signature

8-24-09

Date

PLACE IN RETURN BOX to remove this checkout from your record.
TO AVOID FINES return on or before date due.
MAY BE RECALLED with earlier due date if requested.

DATE DUE	DATE DUE	DATE DUE

**HEADS THE S&LS WIN, TAILS THE TAXPAYERS LOSE: THE POLITICS
BEHIND REGULATION AND DEREGULATION OF THE SAVINGS AND LOAN
INDUSTRY**

By

Jill S. Huerta

A DISSERTATION

**Submitted to
Michigan State University
in partial fulfillment of the requirements
for the degree of**

DOCTOR OF PHILOSOPHY

History

2009

ABSTRACT

HEADS THE S&LS WIN, TAILS THE TAXPAYERS LOSE: THE POLITICS BEHIND REGULATION AND DEREGULATION OF THE SAVINGS AND LOAN INDUSTRY

By

Jill S. Huerta

Though it has received little attention from historians, the savings and loan industry played a vital role in the 19th and 20th century U.S. financial system. The earliest savings and loan institutions, which were small, cooperative self-help ventures, filled a void in the financial marketplace, which offered few home finance options that met the needs of average workers. Savings and loans allowed Americans with modest means to participate in the activity of home ownership. During the Great Depression, the Hoover and Roosevelt administrations created a regulatory structure and a host of programs that made the federal government a major player in the home finance market in order to encourage and expand home ownership. This helped savings and loans to become the largest writers of home mortgages in the country by the mid 1950s. However, by the early 1970s, changes in the global economic structure and corresponding adjustments to U.S. financial markets had made savings and loans less essential. Home finance had gradually become integrated into the larger U.S. capital market, which took over the function of bringing together savers and borrowers previously performed by savings and loans. As institutions suffered under the new conditions, the federal government chose to address the problem through partial deregulation of the industry, which ultimately

worsened the problem, delayed the implementation of genuine solutions, and exponentially increased taxpayer liability.

This dissertation traces the history of the savings and loan industry from its humble beginnings in 1831 through its collapse in the late 1980s. Sitting at the intersection of politics and economics, it analyzes decisions made by the federal government to support, regulate, and deregulate the industry in the context of large economic change. It especially emphasizes the formation of deregulatory policies and legislation in 1980 and 1982, carefully examining the political forces involved in crafting laws; and identifying individuals, interest groups, and regions that lobbied for and benefited from them. This historical narrative, on the most basic level, acts as a case study of how one industry was affected by and reacted to changes in the trajectory of U.S. capitalism over time. On a deeper level, it sheds light on the way in which various segments of the elite class vied for advantage, viewing economic regulation as an arena for competition among powerful groups. Most important, this study highlights the critical historical moment when American capitalism forged a new path. The savings and loan debacle unfolded just as key transformations were in their infancy. The idea of deregulation had just begun to captivate the minds of intellectuals and policymakers; and the financial market was just beginning to become more complex and less transparent. These trends continued throughout the remainder of the 20th century and became key features of the financial crisis of 2008. By that time the American economy looked more like a casino than like a global industrial power. Today, the U.S. economy continues to struggle with the wider ramifications.

Copyright by
JILL S. HUERTA
2009

ACKNOWLEDGEMENTS

In completing this project I have received much support and it is with great pleasure that I take this chance to express my gratitude. During my time in the doctoral program at Michigan State University, my advisor, Mark Kornbluh, has always been there when I needed him. His mentoring, both in the classroom and throughout this project, has profoundly shaped my understanding of U.S. political economy. Furthermore, he encouraged me to take on a difficult topic, one with great potential to deepen our understanding of current political and economic issues, and that has made all the difference. The other members of my committee have all made key contributions to my thinking. Lisa Fine has given me invaluable insight into the U.S. labor movement, with all its strengths and flaws; Lewis Siegelbaum patiently saw me through thousands of pages of Karl Marx and other works that proved even more challenging; and David Bailey taught me how deeply capitalism affects every aspect of American society. Before her death, Mary Cookingham devoted precious time and energy to enhancing my knowledge of economic history.

The History Department at Michigan State University has generously supported my work through numerous assistantships and two Summer Research Enhancement Fellowships. In addition, the Graduate School's Dissertation Completion Fellowship allowed me to devote my full time to writing for several months. During my research, librarians at Michigan State and the University of Michigan provided frequent and

helpful assistance and the staff at the Jimmy Carter Presidential Library showed me true hospitality.

On a personal level, many people have helped me find the stamina and focus that a project such as this requires. My parents, Rhoda and Myron Derman, gave me a childhood rich with opportunities and taught me the importance of education, self-discipline, and work ethic. My children, Arthur, Gaby, and Skye, supported me in countless ways, ranging from cups of coffee and hand-drawn cards during comprehensive exams to babysitting for their younger brother, Jett, while I finished writing. My husband and best friend, Jeff, as always, pushed me to ask more of myself. He put his own goals and aspirations on hold so that I could pursue mine. I only hope that I have done justice to that sacrifice.

TABLE OF CONTENTS

INTRODUCTION	1
CHAPTER 1	
THE FIRST 100 YEARS.....	8
The 19 th Century U.S. Political Economy.....	8
The Humble Beginnings of Savings and Loans.....	13
Increasing Competition and Regulation.....	17
The Great Depression and the New Deal Reshape the Industry.....	22
CHAPTER 2	
THE NEW DEAL REGULATORY STRUCTURE: 1942-1978	37
The War Years.....	37
1946-1955: Years of Growth and Prosperity.....	42
1956-1966	57
1967-1978	65
CHAPTER 3	
DEREGULATION: THE RESTRUCTURING OF THE NEW DEAL REGULATORY SYSTEM.....	84
CHAPTER 4	
MORE DEREGULATION.....	129
CHAPTER 5	
THE COLLAPSE AND ITS MEANING.....	175
BIBLIOGRAPHY	212

INTRODUCTION

If the global economic crisis of 2008 has taught us anything, it is to appreciate the centrality of the finance system in our modern capitalist economy. It has also highlighted the complexity of that system and called into question our ability to manipulate it and to predict the outcomes it will produce. Economists, money managers, scholars, and policymakers have been humbled. There is much to be learned about the current crisis by studying the savings and loan collapse of the 1980s, as it involves many of the same features that lay at the center of today's economic turmoil. The savings and loan debacle unfolded during the infancy of key trends that affect us today. Financial markets were just beginning to become more intricate and less transparent, and the deregulatory impulse was just starting to captivate the minds of intellectuals and policymakers of both political parties. The savings and loan collapse did not discourage supporters of deregulation or shake their belief that less government oversight would create better outcomes. Instead, deregulation picked up momentum and spread until most of the financial regulation put in place by the New Deal had been undone. This set the stage for the crisis of 2008. Like the current financial meltdown, the savings and loan disaster required an unprecedented government bailout. Yet, historians have barely touched this topic.

To date, the only scholarly historical work covering the S&L crisis is David Mason's *From Building and Loans to Bail-Outs*. In this detailed account of the industry from its birth in 1831 through the 1980s, Mason focuses on four themes: the evolution of the industry over time; the role played by the thrift trade association in the development

of the industry; the relationship between the industry and the government; and the role that savings and loans played in making home ownership part of the “American Dream.” Mason argues that in its first hundred years, S&Ls saw themselves “as being part of a social uplift movement that was more concerned with improving people’s lives than making a profit.” That idea remained attached to S&Ls for a long time, Mason contends, differentiating them from other sectors of the U.S. financial system even through the end of the 20th century.¹

The small number of works that chronicle the industry’s earlier history were produced mainly as memoirs by regulators, or as public relations material by people who worked in the industry.² A number of journalists have published accounts of the savings and loan crisis that provide important descriptions about what happened. However, these books often focus on the more sensational aspects of the disaster, including criminal cases.³ Finally, economists, have studied the crisis as it unfolded and afterwards.⁴

¹ David L. Mason, *From Building and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995* (Cambridge University Press, 2004).

² H. Morton Bodfish, *History of Building and Loan in the United States* (United States Building and Loan League, 1931); Horace Russell, *Savings and Loan Associations* (M. Bender, 1960); Josephine Hedges Ewalt, *A Business Reborn: The Savings and Loan Story, 1930-1960* (American Savings and Loan Institute Press, 1962); Leon T. Kendall, *The Savings and Loan Business: Its Purposes, Functions, and Economic Justification* (Prentice-Hall, 1962); A.D. Theobald, *Forty Five Years on the Up Escalator* (privately published, 1979).

³ See Martin Mayer, *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry* (Charles Scribner’s Sons, 1990); Kathleen Day, *S&L Hell: The People and Politics Behind the \$1 Trillion Savings and Loan Scandal* (W.W. Norton, 1993); Paul Zane Pilzer, *Other People’s Money: The Inside Story of the S&L Mess* (Simon and Schuster, 1989); Stephen Pizzo, Mary Fricker, and Paul Muolo, *Inside Job: The Looting of America’s Savings and Loans* (McGraw-Hill, 1989); Martin Lowy, *High Rollers: Inside the Savings and Loan Debacle* (Praeger, 1991)

⁴ See R. Dan Brumbaugh, Jr., *Thriffs Under Siege: Restoring Order to American Banking*, Cambridge: Ballinger Publishing Company, 1988; R. Dan Brumbaugh, Jr., *The Collapse of Federally Insured Depositories: The Savings and Loans as Precursor*, Garland Publishing, Inc., 1993; M. Manfred Fabritiuis and William Borges *Savings the Savings and Loan: The U.S. Thrift Industry and the Texas Experience, 1950-1988* (Praeger, 1989); Ned Eichler, *The Thrift Debacle*, Berkeley: University of California Press, 1989; James R. Barth, *The Great Savings and Loan Debacle* (The American Enterprise Institute Press, 1991)

My work, which sits at the intersection of economics and politics, chronicles the federal government's efforts to support, regulate, and deregulate the industry within the context of structural change in the U.S. economy. While my work covers the same broad time period as David Mason's book, I emphasize the politics behind the legislative processes that resulted in regulation and deregulation, focusing on the intricate negotiations that took place between presidential administrations, members of Congress, and industry leaders. In critically examining the legislative process, I analyze the motives behind the government's intimate involvement in housing finance after the 1930s, as well as the reasons for radically adjusting the nature of that involvement in the 1980s. I also seek to fit the savings and loan narrative into the larger story of the trajectory of U.S. capitalism over time. The regulatory structure of financial institutions closely corresponded with global structural economic changes and the ways in which the U.S. capitalist system adjusted to them.

I chronicle the rise of regulation, the forces that created the need for regulatory reform, and the political milieu that molded both regulation and deregulation. I argue that the U.S. political system did not always respond quickly or well to the economic imperatives of the industry, because other powerful interests, especially commercial banks, stood to lose or gain from changes to the regulatory structure. Thus, multiple and competing interests struggled to influence legislative outcomes and compromise proved elusive.

Examining the industry from this perspective has allowed me to illustrate important themes. On the most basic level, the savings and loan industry provides a good case study of how the profound structural change to U.S. capitalism in the early 1970s

affected one industry. By the 1970s, many S&Ls found that they were old institutions living in a new world. The new conditions threatened the well-being of the entire industry and demanded that savings and loan business practices and regulations adapt. However, those very adjustments eventually resulted in the disappearance of a large part of the industry. The new economic structure simply had no room for the thousands of small and simple financial institutions that had served their local communities for more than 100 years.

The savings and loan story also highlights the role that technology can play in economic change. The ability of money to move instantaneously from account to account, investment to investment, challenged the old regulatory structure and enabled both investment professionals and individual depositors to demand more from their depository institutions. Technological advances helped to build a national market for deposits and for mortgage lending, and this ultimately called into question the need for specialized institutions, like S&Ls, to carry out these tasks.

Finally, examining the results of S&L regulation and deregulation sheds much light on the way in which various segments of the U.S. capitalist class compete. Changes in regulatory structure create losers and winners. This is especially true with regard to banking, because changes in the allocation of credit have strong reverberations not just within one industry, but throughout the entire economy. The S&L story is the story of billions of dollars moving from east to west, from the Rustbelt to the Sunbelt, and ultimately into the Republican Party. The huge influx of capital funded expansive economic development in the Sunbelt region, and though many S&Ls in the Sunbelt failed during the 1980s, the effects of the business infrastructure, real estate, and political

campaigns that they funded remain with us today. Though the rise to dominance of the Sunbelt and the Republican Party in 1980 was based on many factors, the infusion of large sums of capital into both must be credited for at least part of that ascent.

In chapter 1, I provide background by tracing the S&L industry from its 19th century beginnings, through its first hundred years. During this time the industry remained simple and unregulated. I then examine how thrifts fared during the Great Depression and describe the New Deal overhaul of U.S. depository institutions. I argue that New Deal regulation transformed savings and loans from relatively simple self-help institutions created to fill a gap in the finance market, into a tool of the federal government, used to vastly expand home ownership and spur consumption. In the process, these institutions lost many of the sound economic principles which had guided them for 100 years.

In chapter 2, I follow the industry experience through World War II, postwar prosperity, and through most of the 1970s. During and after the war, the New Deal regulatory system was remarkably successful. However, by the 1960s, inflation and rising interest rates began to put severe pressure on S&L profitability. Congress' attempt to solve the problem with interest rate caps, in some ways made the problem worse, causing disintermediation of deposits from S&Ls to other investments such as money market funds whenever market interest rates rose above the capped rate. Several studies undertaken during this era suggested solutions, but conflicting interests within the financial sector mitigated against regulatory change. The various sectors of the financial market—S&Ls, mutual savings banks, commercial banks, and credit unions—sought to

protect their own interests and refused to compromise. Thus, the chance to solve the problem before a full-scale crisis occurred came and went unrealized.

In chapter 3, which covers the years 1978-1980, I closely examine the process by which financial reform was finally accomplished. I argue that an exceptional set of economic and political circumstances finally allowed the passage of legislation. The feat proved difficult, but the Carter administration worked hard to facilitate the process. The resulting legislation, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), I contend, was an admirable effort to solve industry problems. However, its timing was unfortunate. Just as Congress passed the law, the Federal Reserve's attack on inflation drove interest rates up to unprecedented heights. Under these unusual conditions, the implementation of DIDMCA's reforms actually squeezed S&L profitability and caused net worth problems for some institutions. This opened the door for more financial reform.

In chapter 4, I study the Reagan administration's regulatory and legislative response to S&L problems, which came in the form of emergency relief and radical deregulation of the industry. I argue that the response was constrained by a number of factors, including Reagan's political debt to a broad coalition of business interests that had financed his 1980 campaign, the administration's ideological commitment to deregulation, and the administration's desire to privilege military expenditure over domestic spending. The resulting Garn-St. Germain Act made the problem worse and significantly increased the cost of an ultimate resolution.

In chapter 5, I trace the disastrous consequences of sudden and drastic deregulation. I describe the industry's descent and collapse and explore the reasons for it.

I then examine what this story means, attempting to fit it into the narrative of American democratic capitalist development.

C

the

on

by

the

The

of

between

CHAPTER 1

THE FIRST HUNDRED YEARS

The executives who ran the savings and loan industry of the 1980s would barely **have** recognized the original institutions from which their organizations evolved. The **earliest** savings and loans were private, uncomplicated, self-help mutual associations, **created** to allow average people to pool their savings in order to purchase homes. And **simple** these institutions remained for 100 years. Although savings and loans evolved **slightly** as they spread throughout the country, in 1930 they still performed two basic **functions**: collecting deposits and writing home loans. Furthermore, the 19th century **political** economy in which S&Ls operated considered such endeavors private, and thus the **government** imposed no regulation on the industry. The New Deal's legislative **overhaul** of the U.S. banking system, however, marked the end of the unregulated era for the **savings** and loan industry. For better or for worse, from 1931 onward, S&Ls became **creatures** of the federal government, which privileged the social and political goal of **expanding** home ownership over the outcomes produced by an unregulated home finance market.

The 19th Century U.S. Political Economy

The American savings and loan industry was born in the early 1830s, into a **rapidly** growing and transforming economy. American capitalism stood somewhere **between** its commercial beginnings and the concentrated industrial form it would take by

the end of the century. It was poised to undergo a period of development that would not only change the economy's size and scope, but would also permanently alter American demographics, culture, and daily life. That development was based on technological innovation, improvements in transportation, and advances in corporate law and finance.¹

The tides that gradually and unevenly changed America's economic landscape from individual or family-owned workshops to large industrial public corporations and factories, brought with them immense ripple-effect changes throughout U.S. society. New methods of mass production made possible by technological and financial innovation changed the nature of daily work, and pulled immigrants from Europe and elsewhere into the country by the millions to brave the difficult conditions and low wages the new factory system offered.² Likewise, new methods of production led to massive urbanization, as native citizens and immigrants alike, moved to where the jobs were. By 1900, New York City's population topped 3 million, and Chicago and Philadelphia had reached over 1 million inhabitants.³ The changes wrought by industrialization did not

¹ For improvements in transportation, see George Rogers Taylor, *The Transportation Revolution 1815-1860* (Rinehart & Company, 1951). For legal changes that affected industrial development, see James Willard Hurst, *Law and the Conditions of Freedom in the Nineteenth-Century United States* (The University of Wisconsin Press, 1956) and Scott R. Bowman, *The Modern Corporation and American Political Thought: Law, Power and Ideology* (The Pennsylvania State University Press, 1996). For the development and evolution of the corporation see Naomi Lamoreaux, "The Partnership Form of Organization: Its Popularity in Early Nineteenth Century Boston," in Jack Beatty, editor, *Colossus: The Origins of the American Business Corporation, 1784-1855* (Broadway Books, 2001) and Martin J. Sklar, *The Corporate Reconstruction of American Capitalism, 1890-1916: The Market, The Law, and Politics*, Cambridge University Press, 1988. For changes in corporate structure and the position of the corporation within the U.S. economy, see Alfred Chandler, *The Visible Hand: the Managerial Revolution in American Business* (Belknap Press, 1977) and *Strategy and Structure: Chapters in the History of Industrial Enterprise* (M.I.T. Press, 1962).

² For changes in the nature of work, see Harry Braverman, *Labor and Monopoly Capital*, Monthly Review Press, 1974; David Montgomery, *Workers' Control in America*, Cambridge University Press, 1979; David Montgomery, *The Fall of the House of Labor*, Cambridge University Press, 1987; David M. Gordon, Richard Edwards, and Michael Reich, *Segmented Work, Divided Workers: The Historical Transformation of Labor in the United States*, Cambridge University Press, 1982; Sean Wilentz, *Chants Democratic: New York City and the Rise of the American Working Class, 1788-1850*, Oxford University Press, 1984.

³ U.S. Census Bureau, *Statistical Abstract of the United States*, 2003 <http://www.census.gov/statab/hist/HS-08.pdf> viewed March 21, 2007

stop there. They included fundamental transformations in everything from consumption patterns and birth rates to gender relations and religion.

Banking, as Alexander Hamilton had predicted, played an integral role in the **industrialization process.**⁴ As the savings and loan industry first took hold in the U.S., **national banking was buckling under the concerted attack of Andrew Jackson. After vetoing the Second National Bank's charter renewal in 1832, Jackson withdrew government funds in 1833, making it almost impossible for the institution to function properly.**⁵ State banks reaped the benefits, breaking free from the much resented **regulation carried out by the national bank, and becoming the depositories for federal funds.** The number of state banks rose rapidly, as they filled the void left by the **national bank.** In 1831 there were over 400 state banks;⁶ by 1837, there were 788;⁷ and by 1840 **there were 901.**⁸ Like most corporations during this era, banks operated under individual **charters, created via special acts by state legislatures, in order to provide what was viewed as a valuable public service. State banks extended credit to finance private economic activities and public improvements. They issued notes that circulated as money in routine transactions. They handled state fiscal transactions and even generated revenue for states in the form of taxes, charter fees, and dividends, when the state had an ownership interest in the bank. Charters contained specific conditions and regulations,**

⁴ Alexander Hamilton, "Report on a National Bank to the Speaker of the House of Representatives, 1790," http://american_almanac.tripod.com/hambank.htm accessed March 22, 2007.

⁵ Susan Hoffman, *Politics and Banking: Ideas, Public Policy, and the Creation of Financial Institutions* (The Johns Hopkins University Press, 2001) 57-65.

⁶ *Ibid.*, 72.

⁷ Bray Hammond, "Jackson, Biddle, and the Bank of the United States" *The Journal of Economic History*, Vol. 7, No. 1 (May, 1947) 5-7.

⁸ Glyn Davies, *A History of Money: From Ancient Times to the Present Day* (University of Wales Press, 2002) 482-3.

stipulating the kind of credit banks could issue, the geographic distribution of that credit, **the** chartering of additional banks, and branching requirements.⁹

The characteristics and practices of banks varied from state to state and certainly **by region**, reflecting differences in economies, climates, geography, and population **density** among others. For example, banks in New England tended to be smaller with **fewer** branches, and less state regulation. They issued loans to local artisans, farmers, **and** merchants, who bank managers usually knew well. In 1819, mutual savings banks **began** doing business in the northeastern U.S., generally as philanthropic enterprises. **They** offered workers savings accounts with flexible terms, providing easy access to **funds** during times of hardship or unemployment. Southern banks tended to be fewer, **larger**, and to have more branches. Because of the nature of the southern economy, these **banks** wrote a large number of agriculture and real estate loans, and fewer commercial **loans**. Also, southern and western state governments played a much larger role in **regulation**.¹⁰

In the 1830s and 1840s states began passing general banking laws that resembled **general** incorporation laws. Known as free banking laws, these acts acknowledged banks **as private** institutions created for the purpose of profit, rather than publicly chartered **institutions** created to serve a vital common need.¹¹ Free banking laws, which most **states** adopted by the Civil War, granted uniform conditions and regulations to all

⁹Susan Hoffman, 70-74.

¹⁰Susan Hoffman, 75-77; Howard Bodenhorn, *A History of Banking in Antebellum America: Financial Markets and Economic Development in an Era of Nation Building* (Cambridge University Press, 2000) 32-44.

¹¹ Michigan and New York were the first to pass free banking laws in 1838. See Glyn Davies, 482.

incorporated banks. In many states, they served mainly as a formality because charters had already become standardized.¹²

Banking remained a state-centered activity until the economic strain of Civil War **left the** federal government severely short on cash. Initially the government sold bonds to **banks** for payment in gold and silver, but the drain on specie became so serious that **eastern** banks had to suspend their payment of notes in December of 1861. The federal **government** then turned to the printing of greenbacks to finance the war, and Secretary of **the Treasury**, Salmon P. Chase, asked Congress to create a national banking system to **coin a** stable and integrated currency. The National Banking Acts of 1863 and 1864 **implemented** a system in which a host of private national banks issued a standardized **currency**, based on bonds purchased from the federal government. The law stipulated **that 17** reserve city banks hold funds equal to 25% of notes and deposits, half in cash and **up to half** in deposits with one of the three central reserve city banks in New York, St. **Louis**, or Chicago. National banks made almost solely commercial loans. The National **Bank Act** also established The Office of the Comptroller of the Currency to examine **these institutions.**¹³

The National Bank Act sought to replace state banks with national ones. As **further** encouragement, the federal government imposed a tax on state bank circulation in **1866**. Furthermore, several subsequent Supreme Court decisions outlawed state bank **notes**. While this initially led to a steep drop in the number of state banks, they began to **reappear** when they discovered they could circumvent prohibitions against issuing

¹² Susan Hoffman, 77-89.

¹³ Susan Hoffman., 91-94; Glyn Davies, 491.

currency by supplying borrowers with deposit credit rather than notes.¹⁴ States also enticed banks to use state charters over federal ones by offering more lenient regulations with regard to capital ratios and lending. The best efforts to nationalize and standardize banking thus failed and the dual system survived, allowing states to continue granting charters, along with the federal government.¹⁵

The Humble Beginnings of Savings and Loans

The industrial revolution and the migration, immigration, and urbanization that accompanied it created a great need for housing and a corresponding need for home finance during the 19th century. Despite significant development of the banking industry, the market offered limited options for home financing, especially for people of average or modest means. Private state banks preferred to write short term commercial loans, payable in 30-60 days. These banks wrote some home mortgages, but under extremely conservative terms, requiring high down payments of up to 60% of the appraised value of the home. Also, banks offered only short loan terms, usually 1, 3, or 5 years. Borrowers often made interest-only payments, with the full amount due at the end of the term. At that time, homeowners had to find a new lender or reapply for approval with their current lender, paying renewal fees in the process. In addition, homeowners often had to originate second mortgages, written under even less favorable, sometimes usurious terms. Mutual savings banks in the northeast invested their money mainly in low risk state and municipal bonds. Because they offered savers flexibility in withdrawing funds,

¹⁴ Susan Hoffman., 94-97. For more on the National Banking Acts, also see William F. Hixson, *Triumph of the Bankers* (Praeger, 1993) 142-148, and Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War* (Princeton University Press, 1957) 724-734.

¹⁵ Ned Eichler, *The Thrift Debacle* (University of California Press, 1989) 5-6.

these institutions needed to keep their assets more flexible. Therefore, they wrote only a **small** number of mortgages. Though they allowed slightly longer loan terms, they too **required** high down payments.¹⁶ People also turned to insurance companies to finance **their** homes. Life insurance policies sometimes functioned as savings accounts that **people** could borrow from once they had accumulated enough cash value. Again, large **down** payments were the rule. The only remaining alternative was to borrow privately **from** a wealthy individual.¹⁷

Few of these options met the home financing needs of the average worker. Thus **early** savings and loans, initially referred to as building and loans,¹⁸ originated as self-**help** organizations, born to fill a void in the financial marketplace. Savings and loans **allowed** average citizens to pool their resources together in order to purchase homes. The **Oxford** Provident Building Association, established in 1831 in Frankford Pennsylvania, **was the** first savings and loan to operate in the United States. Structured as a mutual **organization**, and modeled after similar institutions in England, it was a simple financial **institution**, with a specialized purpose, and highly restrictive rules about deposits and **loans**. Its members, mainly textile workers, each bought shares in the mutual association **which** they paid for through a down payment followed by fixed monthly payments. Each **time the** association had accumulated enough capital to make a home loan, the funds **were** auctioned off to the member bidding the highest fee and interest rate. Borrowers

¹⁶ James R. Barth and Martin A. Regalia, "The Evolving Role of Regulation in the Savings and Loan Industry," in editors Catherine England and Thomas Huertas, *The Financial Services Revolution: Policy Directions For The Future* (Boston: Kluwer Academic Publishers, 1988) 116.

¹⁷ Susan Hoffman, 156. David L. Mason, *From building and Loans to bail-Outs: A History of the American Savings and Loan Industry, 1831-1995* (Cambridge University Press, 2004) 16-17.

¹⁸ Savings and loans were originally referred to as building and loans, building associations, and sometimes building societies. As the structure of buildings and loans slowly evolved, they came to be called savings and loans. After the New Deal changes to the regulation of financial institutions, S&Ls were also referred to as thrifts. Technically, the term "thrifts" refers to both savings and loans and mutual savings banks.

had to build or buy their homes within 5 miles of Frankford. They continued their fixed **monthly** payments on their shares, in addition to making payments on loan interest and **fees**.¹⁹

Building and loans expected depositors would leave their money in the **association** for its entire existence, and discouraged withdrawals by charging a 5% **penalty** and requiring members to wait 30 days before receiving their money. They also **charged** penalties for late payments. Associations returned profits to shareholders in the **form** of dividends. After 10 years, when each member had purchased a home and repaid the **loan**, the Oxford Provident dissolved. A second Oxford Provident, with a new group of **members**, followed the first and another followed that one, each dissolving when all **loans** had been repaid. This structure was known as the terminating plan. This modest and **simple** model kept costs low and risks at a minimum. The members generally knew **each** other and the community well, making it easy and inexpensive to gather accurate **information** about borrowers and property. Personal character served as a strong **consideration** in loan approval decisions. Community leaders often acted as officers of **these** institutions and frequently carried out their duties voluntarily. For example, **volunteer** trustees ran the Oxford Provident without compensation.²⁰

¹⁹ David Mason, 17-18, Hoffman, 152, Josephine Hedges Ewalt, *A Business Reborn: The Savings and Loan Story, 1930-1960* (American Savings And Loan Institute Press, 1962), 374; Jack W. Cashin, *History of Savings and Loan in Texas*, (Bureau of Business Research, College of Business Administration, The University of Texas, 1956) 4-5; Leon T. Kendall, *The Savings and Loan Business: Its Purposes, Functions, and Economic Justification* (Prentice-Hall Inc., 1962) 4-5. For the early history of the savings and loan industry, also see: M. Manfred Fabritius and William Borges, *Savings the Savings and Loan: The U.S. Thrift Industry and the Texas Experience, 1950-1988* (Praeger, 1989) chapter 2; R. Dan Brumbaugh, Jr., *Thrifts Under Siege: Restoring Order to American Banking*, (Ballinger Publishing Company, 1988) chapter 1.

²⁰ Josephine Ewalt, 374-5; David Mason, 17-18; James R. Barth, *The Great Savings and Loan Debacle* (The American Enterprise Institute Press, 1991) 9-10; John Cashin, 4-5.

Most 19th century workers regarded banks with great suspicion. However, **building** and loans did not have the look or feel of banks. These were grassroots, **cooperative** institutions, serving local communities. They were owned by their **members**—the average workers who deposited their hard-earned dollars—and dividends **were** distributed equally among shareholders. They operated with little overhead and **much** volunteerism and among people who knew each other well. In essence, they served **as a** means for circumventing the banking system, which excluded most workers by **writing** home loans under terms that were out of reach. Savings and loan historian David **Mason** has compared building and loans to other 19th century cooperative movements and **associations** such as the Knights of Labor, Farmers' Alliances, and Populism. He argues **that** **leaders** of the early building and loan industry self-consciously defined their **institutions** as part of a social movement. In promoting building and loans to potential **working** class members and social reformers, they described their institutions as a means **for** **self-improvement**. To workers, they touted their organizations as a way to become **wealthy** through the development of thrifty habits. To reformers, they praised the **positive** effects on individual morality that resulted from homeownership. Movement **leaders** also highlighted the de-radicalizing effects of building and loans, pointing out that **homeowners** were much less likely to oppose the capitalist system.²¹

Building and loans began in the Northeast and Mid Atlantic states and **spread** from there to the Midwest. By the time of the Civil War, building and loans **existed** in seven states; and by 1890 all states had at least one. As these institutions **spread**, their structure evolved. By about 1850, the terminating plan had been largely **replaced** by a serial plan in which new members could join an existing building and loan

²¹ David Mason, 22-28.

by purchasing shares on set periodic dates. By the 1870s, the permanent plan, in which new members could join and purchase shares on a rolling basis and in any denomination, dominated. Over time, building and loans came to separate their services to savers and borrowers. Those who bought shares and deposited their money did not necessarily have to become borrowers, though institutions still expected shareholders to keep their money in the institution long term, and imposed penalties for withdrawal in most states until the 1930s.²²

Increasing Competition and Regulation

During the late 1880s, national savings and loans began to appear, mainly in the Midwest and South. These nationals hired promoters to sell shares either through the mail or by opening local branches. They claimed to be facilitating the movement of money from areas of surplus to regions of need, but many of them used fraudulent practices to make their owners wealthy. While local savings and loans were usually self-help institutions, nationals existed for the sake of profit. They paid their promoters and managers large salaries, resulting in operating expenses that were significantly higher than those of the locals. National institutions spread quickly. By 1893, over 290 national savings and loans spanned the country, and at their most successful point, nationals did business in every state, controlling \$139 million in assets.²³ In 1892, thirteen state associations formed The U.S. League of Local Building and Loan Associations, largely to lobby against the nationals. As the national and local savings and loans competed for business, both types of institutions called for legislation regulating the other. Local

²² James R. Barth and Martin A. Regalia, 115-116, 120; David Mason, 22-29; R. Dan Brumbaugh, Jr., *Thrifts Under Siege: Restoring Order to American Banking*, (Ballinger Publishing Company, 1988) 3-4.

²³ David Mason, 32-33.

associations managed to influence the passage of restrictions on nationals in many states, including blocking the opening of branches and limiting officers' salaries. Some states also passed laws calling for particular industry standards. These laws were usually written by local thrift leaders, in an attempt to privilege their local associations over national ones. The death blow was delivered to the nationals during the Depression of 1893, with half of them failing between 1893 and 1897. The combined effect of the League's success in generating a less favorable regulatory environment, the economic strife of the depression, and the fact that many nationals were fraudulent schemes, led to their disappearance altogether. However, the failure of so many nationals hurt the reputation of savings and loans in general because most of the public did not understand the difference between locals and nationals. The newly formed League had to engage in much damage repair to restore the industry's reputation.²⁴

The League set about doing this by emphasizing the ways in which home ownership improved the individual. They adopted as their motto, "The American Home: The Safe-Guard of American Liberties."²⁵ This was not merely public relations banter. As historian David Mason argues, building and loans should be viewed as a social movement, in fitting with the Knights of Labor and Populism. Their creators believed that home ownership developed individual morals and character. They publicized their institutions as a means for reducing strikes and other forms of social unrest. They founded these institutions to help average people cope with their changing environment. Mason also emphasizes the spirit of cooperation and inclusion in the building and loan

²⁴ David Mason, 34-38; Mark Carl Rom, *Public Spirit in the Thrift Tragedy* (University of Pittsburgh Press, 1996) 26-27; Barth and Regalia, 120; Susan Hoffman, 158; John Cashin, 15-19; Leon Kendall, 6.

²⁵ Kathleen Day, *S&L Hell: The People and the Politics Behind the \$1 Trillion Savings and Loan Scandal* (W.W. Norton & Company, 1993) 40. This motto appeared on the League's letterhead until 1992.

movement. Women, for example, participated heavily in both membership and management of these organizations. Furthermore, ethnic groups often formed their own institutions, holding meetings in local taverns, to lift up fellow group members and draw their communities closer together.²⁶

Regulation of building and loans developed slowly and varied by state. During the 1860s, some industry leaders sought state oversight to protect them from competition, to ensure safe operation, and to enhance public confidence in thrifts. Ohio, Pennsylvania, and Illinois led the way in enacting regulation. New York was first to require the filing of annual reports with a banking commissioner and in 1887 it required state examinations. The failure of so many national building and loans in the 1890s, led to an increase in regulatory statutes, which industry leaders desired and often drafted themselves, through the League. By 1900, all states had some form of regulation, usually limited to reporting and examination requirements. Besides guarding against fraud and insider abuse with varying degrees of intensity, examiners confirmed that thrifts used their deposits only to write home mortgages, keeping the industry simple and the risks low. States also restricted the number of charters granted in order to limit competition.²⁷

In 1913, Congress significantly expanded federal involvement in and regulation of commercial banking with the passage of the Federal Reserve Act. Responding somewhat to the panic of 1907, the system sought to impose order and coordination on the nation's banking system by providing a lender of last resort to solvent banks experiencing a panic-induced run.²⁸ The act also sought to create a more elastic currency

²⁶ David Mason, 22-27, 54; Kathleen Day, 40-41.

²⁷ David Mason, 70-74, Barth and Regalia, 117; Susan Hoffman, 158.

²⁸ William F. Hixon, *Triumph of the Bankers: Money and Banking in the Eighteenth and Nineteenth Centuries* (Praeger, 1993) 177-179; Glynn Davies, 501.

that would self-adjust based on the credit needs of business, and to respond to critics who claimed that the national bank system funneled money to the reserve city banks, particularly New York, which then channeled the funds into the stock market.²⁹ Thus, the Federal Reserve System divided the country into 12 districts, each with its own reserve bank. The law required that all national banks become members, but gave state banks the option to belong or not. Member banks were to deposit their reserves in the district reserve bank, and could borrow funds to cover withdrawals or to make loans. The Federal Reserve Board had the responsibility of supervising the district banks. Over time, the Federal Reserve System became a means for conducting national monetary policy by adjusting reserve requirements and interest rates.³⁰

No such system existed for savings and loans, which at this time, were regulated only at the state level. The Wilson administration made an overture to the industry in 1919, inviting the League to a housing conference. The administration had drafted an act for the building and loan industry that looked much like the Federal Reserve System, but industry support was split and the bill failed in Congress. It would be more than 10 years before the federal government became involved in the industry again³¹

During the late 19th and early 20th centuries, savings and loans grew considerably, from 5598 institutions throughout the country in 1893 to about 12,000 by 1930.

Together, the roughly 12,000 institutions held about 10% of the savings accumulated by

²⁹ Glyn Davies claims that from 1914 to 1928, the Federal Reserve system indeed became dominated by New York "where policy was determined predominantly by the demands of Wall Street and of the international money market, moderated, if at all, by whatever influence the Washington Board of Governors could exert against the dominant personality of Benjamin Strong, Governor of the Reserve Bank of New York." Glyn Davies, 505.

³⁰ Susan Hoffman, 111-125; R. Dan Brumbaugh, Jr., *Thriffs Under Siege: Restoring Order to American Banking* (Ballinger Publishing Company, 1988) 142-144; Robert L. Heilbroner and Aaron Singer, *The Economic Transformation of America: 1600 to the Present* (Wadsworth, 1999) 212.

³¹ David Mason, 74-75.

the American public and wrote mortgages on over 2 million homes. This amounted to 22% of all mortgages. Small institutions dominated the industry, with most possessing less than one million dollars in assets, and fewer than 90 associations having more than ten million dollars in assets.³²

Building and loans offered more favorable home loans than other financial institutions. Nonetheless, these were not the mortgages that we are familiar with today. Even savings and loans, required large down payments, 33-60% by the 1920s, 25-35% by 1930, with many people taking out second mortgages to meet that requirement. S&L loan terms, though twice as long as those offered by commercial banks, still proved to be short, 8-12 years. Frequent refinancing meant that borrowers carried the risk of fluctuating interest rates, gaining or losing ground when rates changed.³³

During the early 20th century, savings and loans began to face mild competition from private commercial banks and other mortgage companies. Commercial banks acquired the right to offer savings accounts in the early 1900s, and they had good reason to take advantage of the new opportunity. The American public was saving more money, and for Federal Reserve member banks, reserve requirements were lower for savings accounts than for demand deposits. Thus, individual savings became a cheap source of capital, which an expanding and innovating national economy clamored for in order to undertake larger projects.³⁴ Commercial banks also became more interested in writing mortgages, though national banks could not write loans secured by real estate until

³² Josephine Ewalt, 3-5; Barth and Regalia, 115-116; David Mason, 61; Susan Hoffman 156.
³³ David Mason, 52-59.
³⁴ Barth and Regalia, 120.

1927.³⁵ Savings and loans also faced competition from mortgage brokers and mortgage companies which wrote about 5% of all home loans by 1929. In general, however, the developing competition did not present a major problem to the industry.³⁶

Thus, the first 100 years of the S&L industry were relatively sedate, characterized by steady growth and slight evolution of structure and practices, the beginnings of regulation, and the creation of the League. The basic mode of operation remained the same. Institutions used short term funds, in the form of deposits, to invest in fairly short term assets, mortgages. The borrowers carried as much or more of the risk as the lenders. In addition, savers had incentive to investigate and closely follow the soundness of their depository institutions; not a difficult task since savings and loans remained simple institutions that performed very few functions in a local market. If an institution became unsound, discipline was administered by savers who had an incentive to place their funds elsewhere.³⁷

The Great Depression and the New Deal Reshape the Industry

³⁵ Martin Mayer, *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry* (Charles Scribner's Sons, 1990) 30.

³⁶ David Mason, 65.

³⁷ Kenneth Snowden agrees that building and loan members had incentives to monitor all the activities of the institutions to which they belonged, because greater profitability meant higher dividends and quicker loan pay-offs. "Given this common 'profit motive', the entire membership had incentives to assure that the association made safe loans, that other members paid dues, interest and premium charges promptly, and that the administrative expenses of the association were kept to a minimum." However, he argues that the local nature of building and loan markets was not attributable to the need to monitor fellow members. Rather, he contends that the main reason for localization was the fact that organizers and directors of building and loans were homebuilders who were interested in providing a means for financing homes that they built in the local community. They therefore acted as directors for little or no compensation and recruited local real estate professionals to act as secretaries. Real estate agents also worked for little or no pay because they too needed building and loans to finance home purchases. In essence, Snowden argues that building and loan staffs and boards were filled with conflicts of interest, but ones that balanced each other. Real estate professionals who had incentive to write more, even perhaps risky loans were held in check by homebuilders who wanted only to sell homes they had built. See Kenneth A. Snowden, "Building and Loan Associations in the U.S. 1880-1893: The Origins of Localization in the Residential Mortgage Market," *Research in Economics* (1997) 51, 227-250.

While many believed that the unfettered and unregulated market tended to create sensible and rational business practices, the Great Depression showed that it could also wreak havoc, chaos, and suffering. By 1933, the unemployment rate had grown five fold. The Federal Reserve's index for industrial production, 110 in 1929, fell to 91 in 1930 and plummeted to 58 by 1937. The economy witnessed severe deflation as business people and average Americans alike cut their spending. Wholesale prices dropped almost a third from 1929 to 1932. Investment practically stopped. The American economy functioned at a fraction of its potential capacity. And banks failed in large numbers—20% by 1933.³⁸

Bank failures became so severe that by the time Roosevelt took office in March of 1933, the system barely functioned.³⁹ The new president declared a banking holiday from March 6-9, with some Federal Reserve banks reopening on the 9th. By June, the American banking system stood forever altered, and the government had become a major player in the U.S. financial system. The Glass-Steagall Act, passed in June of 1933, addressed some of the ills that leaders perceived had caused the Great Depression. The act separated commercial banking from investment banking to discourage speculation on the stock market using deposits. Perhaps its most significant provision involved the creation of the Federal Deposit Insurance Corporation (FDIC) to insure individual deposits up to \$5,000. This controversial modification to the banking system persuaded people that it was safe to deposit their cash in banks again. The act also sought to reduce

³⁸ Joseph Finkelstein, *The American Economy: From the Great Crash to the Third Industrial Revolution* (Harlan Davidson, Inc., 1992) 9-10, 17. For more on the Great Depression and the New Deal, see William E. Leuchtenburg, *Franklin D. Roosevelt and the New Deal* (Harper & Row, 1963), Alan Brinkley, *The End of Reform: New Deal Liberalism in Recession and War* (Vintage Books, 1995).

³⁹ From 1930-1933, 8812 banks failed. The average annual rate of failure for banks during the 1920s was 600. See Glyn Davies 512.

competition among banks by prohibiting the payment of interest on demand deposits and limiting the interest banks could pay on savings to a rate established by the Federal Reserve Board. The Fed exercised this power under Regulation Q. These provisions were intended to alleviate earnings pressure on banks by lowering their interest costs and thus eliminating the need for risky, high-yielding investments.⁴⁰ The prohibition of interest on demand deposits also removed the incentive for small banks to deposit their funds in larger city banks that might channel those funds into the stock market.⁴¹

The Banking Act of 1935 made the FDIC a permanent institution and gave the Federal Reserve Board greater powers to manipulate the money supply, through reserve levels, discount rates, and the buying and selling of government securities. The Securities Act of 1933 was the first federal regulation that dealt with the offering of public securities by a private corporation and the Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC) to supervise and regulate the secondary securities markets in order to protect investors.⁴²

Saving and loan institutions encountered considerable hardships during the Great Depression, although they did not, generally, experience the kind of runs on deposits and failures suffered by commercial banks. Ironically, their greatest losses came from the failure of commercial banks that served as depositories for their cash and as a source for short-term borrowing. Many S&Ls either lost their deposits in failed commercial banks or found their short-term loans called by distressed banks. At the same time, savings and loans faced falling deposit levels and rising withdrawals, as savers, strained by the depression, needed their funds to pay for the cost of living. Withdrawals hit savings and

⁴⁰ Glyn Davies, 515; Heilbroner and Singer 289-291.

⁴¹ Susan Hoffman, 120-130.

⁴² John Finkelstein, 17-18; Susan Hoffman 135-6; Heilbroner and Singer 290-291.

loan institutions particularly hard because almost all their assets were tied up in illiquid mortgage loans and their reserve levels were notoriously low. Many associations found they could not pay out immediately when members made withdrawals. They had the right to take 30 days to pay, but by tradition they had always paid immediately. Some thrifts became “frozen,” meaning depositors could not withdraw their funds at all.⁴³ In addition, increasing unemployment led to rising mortgage default levels. Savings and loans therefore found themselves owners of a considerable amount of real estate that had plummeted in value. The result of all these problems was an unprecedented number of failures in the 1930s, a problem with national economic significance because it “severely limited the flow of funds to housing.”⁴⁴ In fact, Morton Bodfish, the U.S. Savings League’s chief executive during the Great Depression argued that “One-half of the counties in the United States as a result of the Great Depression now had no mortgage loan institutions or facilities.”⁴⁵

Housing comprised a large enough sector of the overall economy and an important enough political issue to make this unregulated market outcome unacceptable to the federal government. Both the Hoover and Roosevelt administrations pursued a whole new economic mission in the wake of the suffering and chaos of the 1930s. For the first time, the U.S. government assumed responsibility for “putting a floor under GNP and a ceiling on unemployment and guaranteeing a minimum standard of living.”⁴⁶ The savings and loan industry, represented by the U.S. League, urged the federal government

⁴³ Ned Eichler, *The Thrift Debacle* (Berkeley: University of California Press, 1989), 8-9; Ewalt, 14-21; David Mason 77-79.

⁴⁴ Barth and Regalia, 124.

⁴⁵ Morton Bodfish, *History of Building and Loan in the United States* (U.S. Savings and Loan League, 1935) 22.

⁴⁶ Ned Eichler, 2.

to

ac

th

ge

be

cr

an

in

Co

be

ho

so

fe

Co

Joe

co

lar

re

Gay

OW

PTU

—

^cS
^aD

to provide relief and support for their industry. The Hoover and Roosevelt administrations, as well as Congress, responded with a barrage of legislation relevant to the savings and loan industry. These laws created a new relationship between the federal government and financial institutions as well as between the federal government and homeowners. They made the savings and loan industry a quasi-public endeavor, a creature of politics, rather than a solely private undertaking.

Herbert Hoover initiated the first federal intervention of this era to affect savings and loans. A strong believer in the importance of home ownership, Hoover took an interest in housing long before he became President. During his tenure as Secretary of Commerce, he created the Division of Building and Housing, which published advice on housing-related issues such as zoning, building codes, architecture, building materials, house plans, and financing.⁴⁷ As president, Hoover not only tried to help the industry solve its temporary emergency, but also began devising a system to permanently inject federal funds into the housing finance market. In 1932, per Hoover's suggestion, Congress created the Reconstruction Finance Corporation (RFC) to provide temporary loans to struggling businesses, including financial institutions, railroads, life insurance companies, industrialists, and agriculture. The temporary measure, however, hardly targeted S&Ls. Of the \$2 billion lent by the RFC in 1932 and 1933, the S&L industry received only \$125 million.⁴⁸ To provide a more permanent solution to the industry's capital shortage, in the fall of 1931, Hoover held the President's conference on home ownership, which triggered discussion and study of the home finance market. Hoover's proposal involved the creation of a Federal Home Loan Bank System, which would

⁴⁷ Susan Hoffman, 150-151.

⁴⁸ David Mason, 79-81.

C

d

d

m

k

T

ke

th

te

in

th

pe

S

in

sc

en

de

a

T

/

7

8

operate much like the Federal Reserve, advancing capital to lending institutions through district federal banks.⁴⁹

According to Horace Russell, the various sectors of the U.S. financial market **disagreed** about the need for this legislation. Russell served as counsel to the League and **to the** Federal Home Loan Bank Board and wrote a first-hand account of the savings and **loan** industry during this era. Banks and insurance companies, which he characterized as **“in and out of the mortgage market as investors,”** for the most part opposed the **legislation**, explained Russell. However, savings and loans, which stood to benefit from **the legislation**, had an interesting reaction. Initially many associations supported only **temporary** assistance from the government, arguing that once the crisis abated, member **institutions** would once again be able to generate all the capital they needed. Over time, **the industry** position changed, but early opposition to public housing in general and to a **permanent** government role in the industry explained, “why the Federal Home Loan Bank **System** and related enterprises have been developed with a minimum of Government **intervention** and control and with a maximum of local management responsibility upon a **sound** basis,” Russell argued.⁵⁰

David Mason too discusses resistance to Hoover’s plan. Bankers and insurance **executives** opposed the plan because they objected to the creation of such a “narrowly **defined**” permanent institution, he argues. They also saw the plan as an over-reaction to **a temporary** crisis situation. Some S&L industry leaders also objected, notes Mason. **They** were hesitant to see the “federal government directly involved in the mortgage

⁴⁹ Josephine Ewalt covers Hoover’s introduction of this proposal and the process by which it became legislation. See Josephine Ewalt, chapter 4; Horace Russell, *Savings and Loan Associations* (Matthew Bender & Company, 1960) 40.

⁵⁰ Horace Russell, 39-42.

business and insisted that any program created to help lenders be temporary...”⁵¹

However, eventually the industry leaders accepted the new government role and worked to mold it towards their own preferences, notes Mason, quoting Morton Bodfish’s explanation that “we must do something, or something may be done to us.” Josephine Ewalt, Assistant Vice President of the U.S. League, claimed that mortgage bankers also opposed the legislation, explaining that they, like commercial banks, and insurance companies, “looked with disfavor on legislation that would give savings and loan associations a new place in the economy.”⁵²

Objections notwithstanding, the Federal Home Loan Bank Act, drafted by the Commerce Department, the Federal Reserve, and the U.S. League,⁵³ was passed and signed by Hoover in July of 1932. This was possible, argues David Mason because opponents did not “wage a coordinated attack to defeat the bill, as both the Mortgage Bankers Association and the American Bankers Association put up only nominal resistance.” The League, on the other hand, lobbied tirelessly.⁵⁴ As the bill moved through Congress, savings and loan representatives testified supportively before Congress and the U.S. League helped to recruit business leaders outside the industry to testify as

⁵¹ David Mason, 78-83.

⁵² Josephine Ewalt, 52.

⁵³ David Mason lists all three of these groups as responsible for the drafting of Federal Home Loan Bank Act. See David Mason, 83. Horace Russell especially credited Morton Bodfish, then the young Vice President of the U.S. League, William E. Best, the League’s president, and J.F. Cellarius, the League’s Secretary for contributing to the legislation. He did not mention his own role, but this may have been out of modesty because in his book’s preface, his publisher claimed that Russell “is considered the dean of advisers in this field, having drafted most of the laws, regulation and forms under which Savings and Loan Associations presently operate.” See “Publisher’s Preface,” in Horace Russell, *Savings and Loan Associations* (Mathew Bender & Company) 1960, iii. Russell did acknowledge his role in supporting the legislation by testifying before the House Committee on Banking and Currency. See Horace Russell, 43. Also, Susan Hoffman also claims that the U.S. League worked closely with the Commerce Department in drafting the legislation. She adds that as the bill was in Congress, the League worked with members of the House to adjust the original draft and that “they orchestrated substantial support for the measure during the hearings, drumming up telegram campaigns and gathering data and preparing analyses requested by the administration and congressional committees.” See Susan Hoffman, 165.

⁵⁴ David Mason, 86.

well. After the bill's passage, the League sent out bulletins explaining the new system and urging its members to participate.⁵⁵ Susan Hoffman also credits the Hoover administration for their vision in creating the Federal Home Loan Bank system and their work with Congress in facilitating the bill's passage.⁵⁶

The act sought to provide more funds to all institutions that wrote mortgages, including savings and loans, savings banks, and insurance companies. Modeled after the Federal Reserve System, the Federal Home Loan Bank System established 12 regional banks, with stock owned by member institutions and the government. Members borrowed from regional banks against mortgages on their books. Susan Hoffman claims that the rules regarding borrowing were set up by the Hoover administration to promote a "flow of society's financial resources into home ownership," and to encourage the long-term amortized mortgage to become the industry standard. Mortgages written under a variety of terms qualified as collateral for borrowing purposes. However, institutions using long-term, fully amortized, loans as collateral were permitted to borrow more. In addition, mortgages used as collateral had to be for 1-3 family residences worth no more than \$20,000. This prevented the funds from flowing into rental housing and encouraged financial institutions to write mortgages with favorable terms for middle and working class families trying to buy standard, not overly luxurious homes.⁵⁷

Another purpose of the Federal Home Loan Bank system lay in providing a steady stream of capital for home purchasing across all regions of the country, or as Horace Russell explained, for the purpose of "transferring excess savings in one area and not required in that area for home mortgage credit to other areas of the country where

⁵⁵ Josephine Ewalt, 49-57.

⁵⁶ Susan Hoffman, 167.

⁵⁷ Susan Hoffman, 160-164; David Mason, 82-86

such savings are temporarily deficient and where there is a greater demand, therefore, for home mortgage capital.”⁵⁸ Thus, Federal Home Loan Banks could lend to and borrow from each other and place deposits in other Federal Home Loan Banks in order to spread mortgage funds throughout the country. The system also allowed member banks to hold their deposits in their Federal Home Loan Banks rather than in commercial banks, where they had experienced painful losses during the Great Depression. The new legislation also helped the suffering home construction industry.⁵⁹

In terms of administration, the act provided for a Federal Home Loan Bank Board (FHLBB) to supervise the regional banks. It was to be composed of five members, appointed by the President with the consent of Congress, and a Chairman selected by the President. The FHLBB appointed about 1/3 of the directors of the regional Federal Home Loan Banks while member thrifts appointed the other 2/3 of the directors. The Federal Home Loan system remained in place until 1989.⁶⁰

In April of 1933, the federal government intensified its campaign to boost housing and the savings and loan industry with the passage of the Home Owners’ Loan Act. Again, the savings and loan industry played a vital role in the legislative effort. Horace Russell, former president of Atlanta’s largest Savings and Loan, and Federal Home Loan Bank Board general counsel drafted the legislation, with input from other members of the Bank Board and the Roosevelt administration.⁶¹ This act created the Home Owners’ Loan Corporation (HOLC) in response to the astronomically high rate of home

⁵⁸ Horace Russell, 0.

⁵⁹ *Ibid.*, The Federal Home Loan System is also discussed in Walter J. Woerhide, *The Savings and Loan Industry: Current Problems and Possible Solutions*, Quorum Books, 1984, chapter 1. Also see Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*, Oxford University Press, 1991, chapter 4.

⁶⁰ *Ibid.*, Walter Woerhide, 4; Lawrence White, 54.

⁶¹ David Mason, 91.

foreclosures during the early years of the depression. By 1933, 40% of the nation's \$20 billion of home mortgage debt was in default. By June of 1933 an average of 1000 foreclosures occurred each day. The HOLC bought distressed mortgages from private lenders, compensating them with low-yielding, yet reliable bonds. Then the organization refinanced with the borrowers, offering more favorable terms, including lower interest rates, 15-year amortization, and interest only payments. Loans also covered taxes, liens, and essential maintenance. For the first time, the federal government became a direct lender to homeowners.⁶² The terms offered by the HOLC were so much more favorable than standard private market terms, that many borrowers intentionally defaulted on their mortgages in order to become eligible for HOLC refinancing.⁶³ These lending activities spanned from June of 1933 to June of 1936, during which time the HOLC refinanced 1/6 of the nation's total mortgage debt, including \$770 million of mortgages held by savings and loans, \$525 million held by commercial banks, \$410 million held by mutual savings banks, \$165 million held by insurance companies, and \$196 million held by mortgage finance companies.⁶⁴ Designed to be temporary, the HOLC terminated in 1951 after returning a small profit to the national treasury. Its major significance lay in its pioneering of longer term, fixed-rate home loans that eventually came to represent the industry standard.⁶⁵

The Home Owners' Loan Act also authorized the FHLBB to charter federal savings and loan institutions and provided matching funds for every \$1 of local savings

⁶² Josephine Ewalt, 36-41.

⁶³ *Ibid.*, Josephine Ewalt, 40. Ewalt noted that there was an additional problem with this phenomenon. It erodes people's sense of responsibility to their debts. The moratoria on foreclosure enacted in many states also contributed to the problem. "...the public psychology created by legal arrangements to postpone any foreclosure was detrimental to general borrower observance of contract," she explained.

⁶⁴ Josephine Ewalt, 36-41; Susan Hoffman, 168-172.

⁶⁵ Mark Carl Rom, 30-33; David Mason, 91-92..

invested in a federally chartered savings and loans, with a limit of \$100 million. In 1934, the federal government raised matching funds to \$3 of federal funds for every \$1 of local savings, and in 1935, Congress allowed state-chartered savings and loans to participate in this program as well.⁶⁶ Home loans written by federal savings and loans had to be located within 50 miles of the institution's main office, and the homes had to be appraised for \$20,000 or less, again to encourage home ownership dollars to flow to those in the middle and working classes. Also, the act stipulated that federal charters had to be mutual organizations. With the Home Owners' Loan Act, the government began injecting funds directly into the housing market.⁶⁷

A year later, the government took yet another step in nurturing home ownership with the passage of the National Housing Act of 1934. This act, which Horace Russell also drafted, created the Federal Savings and Loan Insurance Corporation (FSLIC), to insure deposits up to \$5,000 in savings and loan institutions that became members. FSLIC charged insurance premiums of $\frac{1}{4}$ of 1% of insured deposits.⁶⁸ Membership was mandatory for federally-chartered savings and loans, and optional for state-chartered institutions. The insurance offered by FSLIC stipulated that depositors of a failed institution be compensated with either an equal account in another insured institution or with a 10% cash payment of their deposits, with the balance following within one year. FSLIC's deposit insurance sought to encourage funds in the form of individual personal

⁶⁶ Josephine Ewalt, 44-47; Susan Hoffman, 168-172..

⁶⁷ Susan Hoffman, 168-172.

⁶⁸ Lawrence White laments that Congress never considered that FSLIC or the FDIC should charge risk-based premiums for deposit insurance. This, he claims, would have protected the solvency of both funds. The choice to charge level premiums, he explains, was based on the belief that regulation would prevent large losses to the funds and on the unwillingness of banks to pay higher premiums. R. Dan Brumbaugh also discusses the perverse incentives set up by flat premium deposit insurance in R. Dan Brumbaugh, Jr. *The Collapse of Federally Insured Depositories: The Savings and Loans as Precursor*, Garland Publishing, Inc., 1993.

savings, to flow into housing via deposits in savings and loans.⁶⁹ Similar insurance, of course, had already been extended to deposits in commercial banks a year earlier by the Federal Deposit Insurance Corporation (FDIC). However, unlike the FDIC, which was an independent executive agency that need be concerned only with the protection of its fund, FSLIC fell under the jurisdiction of the Office of Management and Budget (OMB). This meant that although FSLIC funded itself through the collection of premium from members, the OMB had the power to review the agency's expenditures.⁷⁰

The National Housing Act also included two other provisions to encourage home financing. Through the formation of the Federal Housing Administration (FHA), the government created federally guaranteed mortgage insurance. This encouraged banks and other financial institutions to write mortgages by reducing the risk of default, a true deterrent in the 1930s. It obviously also "fathered a severe form of competition for the savings and loan association. It not only stimulated the mortgage lending activities of commercial banks, which was one of its original purposes, but also brought into being and fostered continually and energetically the mortgage banking business as it is known in mid-century."⁷¹ The initiative to provide federally guaranteed mortgage insurance was the first piece of legislation promoted by the Bank Board that the S&L industry opposed. The objectors were quelled only by the act's inclusion of deposit insurance for thrifts, argues finance professor, William Woerhide.⁷² FHA mortgages would also act as an experimental model for more liberal mortgage terms. During the post WWII era, banks and thrifts examined the loss history of FHA loans that required lower down

⁶⁹ Josephine Ewalt, 100-102; Susan Hoffman 173-175; David Mason 93-95.

⁷⁰ Mark Carl Rom, 59.

⁷¹ Josephine Ewalt, 137-138.

⁷² Walter J. Woerhide, 4-10.

payments and offered longer amortizations, and found that these loans did not lead to disastrous or even unprofitable results.⁷³ In addition, Title III of the National Housing Act authorized the FHA to charter a national mortgage association to buy FHA-insured mortgages, which it did in 1937 with the creation of the Federal National Mortgage Association, more commonly known as Fannie Mae. Again, this served as a means of promoting the housing industry. By buying existing mortgages, Fannie Mae freed capital that could be used to finance more new housing.⁷⁴ The U.S. League actually opposed this part of the bill and tried, to no avail, to have it removed.⁷⁵ In fact the League objected to many of the provisions of the National Housing Act. Horace Russell wrote a memo to the Federal Home Loan Bank Board warning that the legislation would, among other problems, put into effect a discredited mortgage plan, encourage the development of mortgage companies, and encourage speculation. It also “discourages the conservative plans of home financing,” and played into the hands of “Wall Street Finance,” Russell protested. He later admitted that: “the former program did serve substantially to attract commercial bank funds and insurance company funds and promoted home building and the employment of labor. Also, it further encouraged a long term, high percentage, monthly amortized home mortgage loan and improved the quality of home construction.”⁷⁶ The League’s position was not surprising given that the legislation promoted competition from other financial institutions.

In just a few short years, this collection of legislation, much of it requested and formulated by the industry itself, fundamentally changed the nature of savings and loan

⁷³ Eichler, 12-14.

⁷⁴ Eichler, 12-14. New Deal legislation discussed above is also covered in Russell, chapters 6-10.

⁷⁵ David Mason, 93-95

⁷⁶ Horace Russell, 87-93.

institutions in an effort to accomplish the political and social goal of expanding home ownership. To do this, Congress passed legislation that manipulated the outcomes provided by an unregulated home finance market. The federal government provided savings institutions with cheap capital to use for home loans. It encouraged the mortgage industry standard to become the long term, fixed-rate, amortized loan, with the risk of interest rate change carried by the lender. The government directly invested in savings and loan institutions, and encouraged other financial institutions to enter the mortgage business through federally guaranteed mortgage insurance. Federal authorities created Fannie Mae to purchase federally guaranteed loans, freeing up even more capital for home loans. Perhaps most important, the U.S. government offered federal insurance on savings and loan deposits. While savings and loans remained simple institutions, collecting deposits and investing almost solely in home mortgages, an important aspect of the business had changed. Investors could no longer be counted on to scrutinize the business practices of their associations. They had no incentive to do so because their investments were backed by the full faith and credit of the U.S. government. This job would be left to regulators. The simplicity and low-risk philosophy followed so closely by early savings and loans had, to a large degree, been lost.

What had been gained? Obviously, slowing the rate of foreclosure and increasing home ownership had stimulating effects on the ailing American economy. However, perhaps the government's multi-front effort to encourage home ownership accomplished more. Many have argued that Roosevelt's New Deal saved the American capitalist system by tempering its harshest characteristics, by introducing just enough mollifying features to make the system palatable to a suffering population that might otherwise have

become revolutionary. Perhaps housing policy should be viewed in this light. The government's entrance into the housing market allowed huge numbers of ordinary Americans to become property owners. A realm of economic activity that had previously been closed to the majority of Americans became available to an ever-widening group. Whether intended or not, this must have given first-time homeowners the feeling that they finally had a stake in the system, a feeling of inclusion. By 1930 only 2/5 of Americans owned the homes they occupied. With the host of new housing policy put in place in the early 1930s, that was about to radically change.

un

th

h

re

p

er

co

al

le

fo

ri

le

in

by

re

st

I

re

to

CHAPTER 2

THE NEW DEAL REGULATORY STRUCTURE: 1942-1978

The New Deal reforms to the savings and loan industry initially seemed to be an undisputed success. Following World War II, in response to a severe housing shortage, the federal government heightened its efforts to support homebuilding and to encourage home ownership. This, combined with strong demand for housing, led to a massive residential construction boom during the 1940s and 1950s. Savings and loan institutions played an important role in financing this boom. Thus, this era was one of phenomenal expansion, growth, and profitability for the industry. However, by the mid 1960s, conditions changed. A booming economy fueled by government spending at home and abroad, eventually brought about inflation and high interest rates. This put savings and loans under strain. At the same time, new forms of competition emerged during this era for both the savings and the lending functions. Studies undertaken suggested some of the right solutions, but political obstacles prevented these recommendations from becoming legislation. It truly proved to be a missed opportunity. Savings and loans became old institutions trying to succeed in a new system. The lack of flexibility imposed on them by the New Deal regulatory structure and failure of the political system to bring about reform where it was sorely needed made it nearly impossible for them to adjust to the changing economy and put the industry on an unfortunate path towards disaster.

The War Years

The United States' participation in World War II brought about economic and political changes that significantly affected the savings and loan industry. First and foremost, the war brought about a decisive and rapid recovery from the Great Depression

that had ailed the nation for more than a decade. Keynesian federal military spending utilized the full capacity of the American economy and even led to economic expansion. Thus, full employment and rising incomes put money into people's pockets. However, wartime consumer goods shortages made it difficult for people to spend their new windfalls, and therefore led to increased savings among all financial institutions. Savings and loans saw a 60% increase in deposits during the war.¹

At the same time, mortgage lending fell as wartime restrictions on residential construction limited new housing starts. In April of 1942, Construction Conservation Order L-41 prohibited residential building outside of defense area housing without special authorization. Remodeling projects too were almost entirely prohibited.² Savings and loans continued to invest in mortgages on existing homes, which were on the rise as people who had "doubled-up" during the hard times of the Depression could once again afford their own homes. Soon, the one million homes that sat vacant because of defaults during the Depression were once again occupied and real estate prices began rising. Savings and loans, as a group, also invested half a billion dollars in the only residential construction permitted: war housing. However, S&L balance sheets were still skewed with surplus deposits that needed to be invested. Government war and defense bonds proved to be the solution.³

The choice to help finance the war through the purchasing of government securities made a certain amount of sense. The U.S. League of Savings and Loans had a history of portraying the industry as patriotic, especially during the Progressive Era, emphasizing S&L efforts to Americanize immigrants by teaching them thrifty habits and

¹ Robert Heilbroner and Aaron Singer, 307-309; David Mason 120.

² Josephine Hedges Ewalt, 220.

³ Ibid., 208-209.

helping them become homeowners.⁴ Also, regulatory restrictions and tax incentives severely limited other investment options. Therefore, in July of 1942, the officers of the United States Savings and Loan League asked their institutions to add \$100 million in government bonds to their investment portfolios by the end of the year. The League then appointed a representative for each state to ensure that the state's S&Ls filled their quota of government bond purchases. By the end of the war, savings and loans had financed \$3.5 billion, or about 1.3% of the \$270 billion U.S. war debt. Government bonds, which amounted to 1.2% of the industry's total assets in 1940, represented 28% of total assets by 1945.⁵ Still, in 1945 savings and loans had an abnormally high amount of cash on hand.⁶ In addition, savings and loans sold defense and war bonds to the public, with many institutions going to great lengths to procure higher sales. This included setting up booths in hotels and on sidewalks to make purchasing more convenient for the public and developing direct payroll deductions with local businesses. The \$1.6 billion of bond sales accomplished by the industry, no doubt, enhanced its image of patriotism.⁷

Overall, profits for the industry ran abnormally high during the war years. The plentiful nature of savings meant that institutions paid a lower than usual rate of return on deposits. On the other hand, because of the long-term nature of mortgage loans, savings and loan portfolios were dominated, not by wartime mortgages written at lower interest rates, but by mortgages written at the higher rates of the past. Thus, the spread between deposits and loans worked in the industry's favor. In addition, wartime shortages and

⁴ David Mason, 42-46.

⁵ Josephine Hedges Ewalt, 204-206, 210; Francis X. Cavanaugh, *The Truth About the National Debt: Five Myths and One Reality* (Harvard Business School Press, 1996) 26. Also see Leon T. Kendall, *The Savings and Loan Business: Its Purposes, Functions, and Economic Justification* (Prentice-Hall, Inc. 1962) 8.

⁶ Harold W. Torgerson, "Developments in Savings and Loan Association, 1945-53," *The Journal of Finance*, Vol. 9, No. 3 (September, 1954) 294, <http://www.jstor.org/stable/2976565> accessed November 2007.

⁷ Josephine Hedges Ewalt, 206-208.

rationing dampened business spending, so that many institutions did without new office equipment and put off plans to remodel, dropping expenditures even further. The only expense that increased during the war was labor, since most associations continued to pay partial salaries, usually about 10%, to employees serving in the armed forces. Rapid turnover of temporary replacements also increased training costs. In addition, in 1941, the Department of Labor informed the industry that the Fair Labor Standards Act did indeed apply to savings and loans, subjecting associations to minimum wage and overtime regulations to which they did not previously adhere. Finally, in 1940, the industry was required to pay a 1% Social Security withholding tax on payroll for the first time. Despite the higher labor costs, savings and loans enjoyed the most favorable difference between income and expenses during World War II than at any time in the industry's prior history.⁸

While the thrift industry managed to make wartime economic changes work in its favor, industry leaders were far less pleased with wartime political changes that affected the regulatory structure. On February 24, 1942, Executive Order 9070 created the National Housing Agency, a super-agency that consolidated the Federal Home Loan Bank Board (FHLBB), the Federal Housing Administration (FHA), and the U.S. Housing authority, the agency in charge of public housing. The new structure, intended to more efficiently coordinate housing construction and finance, reduced the Federal Home Loan Bank Board from a 5-member board to a single commissioner, minimizing the industry's prestige and influence with lawmakers. As discussed in chapter 1, the industry had grown accustomed to a high degree of involvement in legislation and regulation. U.S. League officials played a key role in shaping the industry's regulatory structure during

⁸ Ibid., 210-212.

the

Pres

app

say

was

bec

ser

lea

wo

gr

in

ho

Op

Su

hi

th

re

be

re

di

—
'N
p

the New Deal, and they found this loss of power disturbing. As U.S. League Vice President, Josephine Ewalt explained, “Savings and loan leaders were shocked and apprehensive and they protested. It took years for the protest to be effective but the savings and loan business never ceased to make clear its stand that the new arrangement was ill-advised and unjust.”⁹

To further the industry’s dismay, the appointed commissioner, John Fahey, became a controversial figure because he viewed the regional federal home loan banks as servants to the public rather than to the member associations that owned them. Industry leaders, on the other hand, believed these banks served as tools to the industry, which would then pass on the benefits they received to the public. Fahey also viewed new growth-oriented and aggressive savings and loan leaders with great suspicion. The clash in outlooks became ugly, eventually leading to Fahey’s consolidation of two regional home loan banks and his seizure of a healthy association, led by one of his enemies. Opposing industry leaders fought back by persuading Congress to form a Special Subcommittee to Investigate the FHLBB and the owner of the closed institution brought his case to court. Acknowledging the disadvantage of putting all regulatory power into the hands of one person, Congress ruled in July of 1947 that a three-person board should replace the commissioner, though Fahey remained president of that board for the time being. In December of 1947, Truman chose not to reappoint Fahey and the new board reopened the closed association, thereby ending the conflict, and appeasing some of the disgruntled industry leaders.¹⁰ The Board however, did not regain its previous clout and

⁹ Josephine Hedges Ewalt., 218-220, quote from 218; David Mason, 123.

¹⁰ David Mason 123-125.

independent status until 1955 when it was removed from the National Housing Agency.¹¹

While the restoration of the board's former stature took a while, S&Ls emerged from the war years in good financial condition, and ready for the challenges they would face during the post war period.

1946-1955: Years of Growth and Prosperity

The decade immediately following World War II brought immense economic growth and prosperity for the United States in general as well as for the savings and loan industry. Though political leaders and average citizens alike feared that the economy would follow the path of the post World War I economy into recession, the worrying proved unfounded.¹² The years after World War II witnessed unprecedented prosperity. Between 1945 and 1960, real Gross National Product (GNP) rose 52% and per capita GNP rose 19%, while prices inflated only slightly.¹³ Spending on personal consumption (measured in constant 1954 dollars) rose 24% between 1947 and 1960 and consumption spending per capita rose 22%. With a baby boom at hand, the population rose rapidly between 1946 and 1964, and innovations occurred across numerous industries.¹⁴

At the center of the economic take-off stood an enormous housing boom that both resulted from and fueled economic growth. As discussed above, demand for housing had

¹¹ Jack W. Cashin, *History of Savings and Loan in Texas* (Bureau of Business Research, College of Business Administration, The University of Texas, 1956) 140.

¹² The expectation of hard economic times following WWII is discussed in Robert Sobel, *The Great Boom 1950-2000: How a Generation of Americans Created the World's Most Prosperous Society*, (Truman Talley Books, St. Martin's Press, 2000) chapter 1. Sobel pokes fun at economists, members of Congress and businesspeople who predicted a postwar recession. He even tells the story of a *Fortune* journalist who predicted a declining birth rate after the war that would create labor shortages and keep older Americans in the jobs longer.

¹³ Robert Heilbroner and Aaron Singer, 307-309; Mansel G. Blackford and K. Austin Kerr, *Business Enterprise in American History* (Houghton Mifflin Company, 1990) 346-347.

¹⁴ Robert M. Collins, *More: The Politics of Economic Growth in Postwar America* (Oxford University Press, 2000) 40.

increased during the war, but was stunted by federal restrictions on residential construction. The government did not lift these restrictions until 1946, fearing that an unregulated home market would bring about heavy inflation.¹⁵ Thus, a significant amount of pent-up demand existed. Fortunately for those who needed homes, the federal government established and continued to support a number of programs that facilitated new residential construction and financing, particularly in the suburbs.

Savings and loans played a major role in financing this tidal wave of residential housing construction. S&Ls not only provided credit for individuals buying homes, but also funded builders undertaking large suburban development projects. In fact, by 1954, the savings and loan industry was the largest source of home mortgages, writing 36.2% of non-farm home loans.¹⁶ All aspects of the business thrived, and return on assets and net worth for savings and loan associations rose throughout this post-war decade.¹⁷

Savings, already pouring in during the war, teemed into S&Ls during the postwar years, increasing 210% between 1945 and 1953.¹⁸ This occurred because savings and loans could offer higher rates of return on deposits than their commercial bank competitors, who were subject to interest rate ceilings on deposits under the Banking Act of 1933. Not surprisingly, S&Ls set their rates higher than those offered by commercial banks in order to attract funds. For example, in 1955, S&Ls paid depositors an average of 2.9% interest; commercial banks paid an average of 1.4%; government bonds paid an average of 2.8%; and local bonds paid an average of 2.6%.¹⁹ S&L interest rates also

¹⁵ David Mason, 129; Josephine Ewalt, 240.

¹⁶ *1965 Savings and Loan Fact Book* (United States Savings and Loan League, 1965) 50; David Mason, 139.

¹⁷ Ned Eichler, *The Thrift Debacle* (University of California Press, 1989) 22-23.

¹⁸ Harold W. Torgerson, 285.

¹⁹ *1965 Savings and Loan Fact Book*, 16.

tended to be high after 1952 because of a change in tax law. Savings and loans historically enjoyed the privilege of exemption from federal income taxes. The benefit stemmed from the fact that they did the important work of providing credit for homeowners. Furthermore, “[a]s mutual organizations, more closely resembling nonprofit organizations than profit-oriented stock associations such as commercial banks, they seemed further to merit this preferential treatment in the eyes of the Congress.”²⁰ In 1952, the federal government required savings and loans to pay income taxes for the first time. However, the new law provided various means for institutions to eliminate or lower tax bills, which most of them did.²¹ For example, associations could put aside reserves up to 12% of the value of their withdrawal accounts, without paying income tax on those funds. In addition, dividends paid to members and money spent on advertising and promotion reduced gross taxable income. Thus, strong motives existed to pay out high dividends, advertise heavily and attract a large flow of savings.²² Given the high demand for home financing, growing S&L deposits flowed directly into housing, somewhat justifying government policies that encouraged deposits to flow into savings and loans rather than into commercial banks.

On the lending side of the business, savings and loans buzzed with activity during these years. As the war ended, S&Ls developed new mortgage products to accommodate the plethora of new homebuyers. For example, they created the Uniform Savings Loan Plan, which offered a 20-year payment period, an option to defer payments temporarily

²⁰ Kenneth R. Biederman and John A. Tuccillo, *Taxation and Regulation of the Savings and Loan Industry* (Lexington Books, 1976) 5; R. Dan Brumbaugh, Jr., *Thriffs Under Siege: Restoring Order to American Banking* (Ballinger Publishing Company, 1988) 147-148.

²¹ The savings and loan industry fought hard against the imposition of taxes on their institutions, which the banking industry demanded because it was subject to income tax. The U.S. Savings and Loan League was not able to defeat the law completely, but did manage to insert provisions to greatly reduce the net effects of such legislation. See Josephine Hedges Ewalt, 300-301.

²² Harold W. Torgerson, 290-291; John Cashin, 137-13.

after the first three years, and the ability to borrow additional funds later for home improvement.²³ Savings and loans were also intricately involved in the development and implementation of Veterans Administration (VA) loans under the Servicemen's Readjustment Act of 1946. As Congress considered and altered the bill, the U.S. League Legislative Committee held conferences with the American Legion's Rehabilitation Committee to discuss methods for financing VA loans. Out of these conferences came the idea of a government guarantee for part of the loan, which Congress adopted in the final act. The government guarantee made lenders more comfortable with financing a higher percentage of the property value, thereby lowering down payments. The lender also charged veterans a below-market interest rate, by about ½%. Once the act became law, representatives of the U.S. League and the Veterans Administration met, along with federal regulators to work out the many regulations necessary for the program to run smoothly.²⁴

Savings and loans were the first financial institutions to write VA loans in their communities. The industry advertised VA loans, printed information pamphlets, and worked with veterans organizations to reach perspective borrowers. According to U. S. League Vice President Josephine Ewalt, the industry worked so hard to promote VA loans because leaders feared that failure of this plan would result in direct government lending to veterans, which the industry saw as a threat to its special role in housing. In 1945, of the \$192 million of VA loans made, S&Ls originated \$175 million of them. In 1946, the first year of heavy volume, S&Ls wrote \$1.25 billion of the \$2.3 billion in home loans to veterans. In 1946, VA loans comprised 35% of all mortgages written by

²³ David Mason, 133-134.

²⁴ Josephine Hedges Ewalt, 229-233; Leon T. Kendall, 8.

savings and loans. Ironically, VA loans permanently changed the parameters of S&L lending. Because of their favorable experience with government guaranteed VA loans, S&Ls came to realize that lending up to 90% of the value of a home, could indeed be a safe investment. By the late 1950s, associations allowed loans of 90% of value without government guarantees.²⁵

Though savings and loans enjoyed great success and growth during this era, not everything went the industry's way. Government influence in housing finance grew considerably during the decade following World War II. In fact, for many industry leaders, the government became too large of a presence in their industry and in housing in general. In addition to guaranteeing VA loans, the federal government, through the FHA, continued its program of guaranteeing mortgages for moderate and lower income Americans, who would otherwise struggle to meet the terms of conventional financing. In the 1950s, Congress made the requirements for FHA loans more lenient, allowing a greater number of Americans to qualify. Congress also allowed the FHA to guarantee financing for apartments and inner-city housing projects. Furthermore, the Federal National Mortgage Association (FNMA, commonly referred to as Fannie Mae), created in 1938, continued buying FHA-insured loans from lenders, thereby increasing the volume of funds available for new mortgages. In 1954, Congress authorized Fannie Mae to buy and sell all types of government-insured loans, and to sell mortgage-backed securities, which channeled investment dollars into the home mortgage market. Savings

²⁵ Josephine Hedges Ewalt, 242-245; Leon T. Kendall, 8-9. Though the Servicemen's Readjustment Act of 1946 provided exciting new opportunities to a large number of veterans, Ira Katznelson reminds us that those benefits were not enjoyed equally. Because the law allowed the states to implement and administer its provisions, black veterans in southern states faced racial discrimination in trying to exercise their benefits, he explains. Though the black community was originally hopeful optimistic about the promise of such legislation, the results proved disappointing. See Ira Katznelson, *When Affirmative Action Was White: The Untold History of Racial Inequality in Twentieth-Century America* (W.W. Norton & Company, 2005) chapter 5.

and loans did not necessarily support or make heavy use of these programs. S&Ls disliked the bureaucratic processes involved in writing FHA loans and objected to the government-set interest rates. Furthermore, savings and loans during this time tended to keep mortgages in their portfolios instead of selling them.²⁶ But industry leaders disliked these programs for a more important reason. Though the industry supported and favored government regulation that made it easier for *savings and loans* to write mortgages, the FHA and Fannie Mae also made it easier for commercial banks and mortgage bankers to write mortgages. These government operations encouraged competition. Savings and loans had to make the terms of their financing more favorable just to compete with these programs, and the writing of so many loans by new actors, perhaps, detracted from the argument that had procured so many privileges for S&Ls: that they were the main institutions meeting the American public's need for mortgage funds. FHA loans indeed met much of the public's need for financing. Between 1945 and 1954, FHA mortgages increased by over 450%, and by 1954, FHA and VA loans together comprised over half of all mortgages on new homes. Furthermore, the vast majority of them were written by commercial banks and mortgage companies.²⁷

The federal government engaged in a number of other activities to support the growth of the housing market during these years. In 1950, Congress passed a bill that lowered the rate that S&Ls paid for deposit insurance from 1/8% of insured savings to 1/12%, and in that same year raised the limit covered by deposit insurance from \$5,000 to

²⁶ David Mason, 143-145; Josephine Hedges Ewalt, 139-145; Norman Strunk and Fred Case, *Where Deregulation Went Wrong: A look at the Causes Behind Savings and Loan Failures in the 1980s* (U.S. League of Savings Institutions, 1988) 21-22.

²⁷ David Mason, 145; For example, in 1954, S&Ls wrote \$209 million in FHA loans; commercial banks wrote \$669 million; and mortgage companies wrote \$682 million. See *1965 Savings and Loan Fact Book*, 56.

\$10,000 per account.²⁸ Of course, the Federal Home Loan Banks continued to advance funds to member savings and loans to increase the capital available for mortgages. In 1949, regulators modified the federal charter, simplifying it, increasing maximum loan-to-value ratios, and allowing for immediate full withdrawal of member deposits. The new charter, known as charter N, also allowed savings and loans to use more customer-friendly words to describe their transactions. Technically, savings and loan members did not have deposits with their institutions – they paid investment dollars towards shares in the mutual association. Yet, the new charter allowed S&Ls to use terms such as “deposit,” “withdrawal,” and “savings account.” The American Bankers Association objected to the new terms, arguing that they made S&Ls sound the same as banks, but to no avail. Many states followed suit with the federal government’s charter improvement, offering similar advantages in their state charters, to prevent institutions from converting their charters.²⁹

Federal, state, and local governments also assisted homebuilding by constructing miles upon miles of highways that allowed builders to develop new areas. State and local governments provided the necessary infrastructure for residential development such as water and sewer lines, roads, and public schools.³⁰

The unprecedented construction boom had stimulating economic effects across a myriad of industries, including concrete, cement, and lumber. It put people to work building sewers, roads, schools and other community services. Furthermore, suburbanites relied heavily on their automobiles for transportation and purchased them in

²⁸ Josephine Hedges Ewalt, 293-294, 297.

²⁹ David Mason, 140-141.

³⁰ Ned Eichler, 20.

ever increasing numbers, giving a boost to the auto industry.³¹ Building the necessary highways kept road workers employed and busy. The suburban construction boom also stimulated numerous retail industries, since new homes created the need for consumer goods, such as appliances and furniture.³² Homebuilding clearly increased American consumption.³³

With stimulating effects such as these, it is no wonder the government implemented a host of policies to encourage housing. Since savings and loans played such an important role in home financing, it seems reasonable that the government would put into practice a wide spectrum of policies aiding the industry. However, the U.S. League's extremely active participation in drafting legislation and formulating regulations caused the Department of Justice to bring a case against the League, alleging that it violated the newly passed Lobbying Registration Act of 1946.³⁴ Though the Department of Justice eventually dismissed the case, Congress took up the cause and the House Committee on Lobbying Activities conducted an investigation of the League in 1949. The investigation, which studied the League's role in housing legislation passed

³¹ Vehicle registration increased from 31 million in 1945 to 62.7 million in 1955. See David Mason, 132.

³² Robert Heilbroner and Aaron Singer, 310; David Mason, 132.

³³ Economist and former staff member of the House and Senate Banking Committees, Robert Dugger, has argued that U.S. economic policies followed the logic of national security, "the highest domestic political priority of any country." In order to fight the Cold War, the U.S. first provided capital to and then became the "consumer-of-last-resort" for Japan, Germany, and ally countries surrounding the former Soviet Union and China. This policy required the U.S. to become a "high consumption, low savings economy," Dugger argues. This provided additional motivation for the government's strong support of the housing market, since homebuilding and purchasing had such a stimulating effect on U.S. consumption. In fact, Dugger referred to housing as "the Lord's work." Interview of Robert H. Dugger by Jill S. Huerta, November 21, 2008. Also see Robert H. Dugger, "Cold War Roots of U.S. Economic Problems," *The Globalist* July 20, 2008, <http://www.theglobalist.com/StoryId.aspx?StoryId=7077> accessed 1/15/2009.

³⁴ Three members of the U.S. League had registered with Congress as lobbyists, but the organization itself had not. See "Loan League Cited on Lobby Charges," Special to *New York Times* (1857-Current file); March 31, 1948; ProQuest Historical Newspapers, 22.

during the prior three years, ultimately found nothing inappropriate about the League's political activities.³⁵

The committee's report published on October 31, 1950, however, offers a glimpse into the League's tireless effort to secure favorable legislation for the industry, especially by its chairman, Morton Bodfish. The report contains documents subpoenaed by the Congressional Committee, which dealt with legislative initiatives covering the period 1947-1950. These included internal League correspondence, correspondence with members of Congress, communications with member associations regarding grass roots political activism, and public relations materials. The fact that over 700 pages of such communications made it into the final report speaks to the vast time and resources the League dedicated to influencing the political and legal environment in which the industry operated.³⁶

These documents reveal that executives of the U.S. League viewed their political position as unfavorable during this era. This stemmed partly from the absorption of the Federal Home Loan Bank Board into the wartime super-agency for housing, The National Housing Agency mandated by Executive Order 9070 in 1942. While the order was supposed to be a wartime measure, several pieces of legislation considered by Congress in 1946 threatened to make this agency permanent, including Reorganization Plan No. 1, and the Wagner-Ellender-Taft bill. The League expressed its negative outlook in its "Report of Federal Legislative Committee 1946." In discussing the activities of the legislative committee during the year, the report explains, "much of our

³⁵ David Mason, 137.

³⁶ House Committee on Lobbying Activities, *Lobbying Activities of United States Savings and Loan League*, 81st Cong., 2nd session, October 31, 1950.

activity has necessarily been of a negative or defensive nature because of the injurious implications of some of the proposals...”³⁷

The 1947 report proved even more pessimistic, breaking the news that Reorganization Plan No. 3, which Truman sent to Congress, had passed the House without debate in June and passed the Senate in July. Plan No. 3 differed from Plan No. 1 in that it created a 3-person Federal Home Loan Bank Board, instead of a 1-person Commissioner. However, the plan still placed the board under the supervision of an executive agency, the Housing and Home Finance Agency. The League’s main problem with this setup lay in its opposition to the public housing effort of the administration. The Housing Act of 1949 obligated the federal government to “guarantee a decent home and suitable living environment for every American family.” Under the act, the government would build 810,000 units of public housing during the next six years and engage in a slum-clearance program. The League viewed public housing as inefficient and detrimental to the private housing market, arguing that the government’s presence in the home construction market would increase the price of homebuilding. Also, the League saw public housing as a socialist initiative and League officials often pulled out their Cold War rhetoric to describe it as such.³⁸ The 1947 Legislative Committee report lamented:

³⁷ Ibid., 35.

³⁸ David Mason, 153-4. Two years later, in a letter to Senator Taft, Morton Bodfish, chairman of the League’s executive committee, criticized Taft for supporting a public housing bill and reminded the senator, “You will recall our concern at the time Reorganization Plan No. 3 was adopted that, instead of coordination and economy, the plan would lead to a continuous program of expanding and enlarging the Agency’s influence and control. It is perfectly clear that every bill prepared by the Housing and Home Finance Agency is going to be generous with the funds, controls, personnel, and powers allocated to the Government housing offices.” Bodfish even played the Cold War card, warning the Republican Taft that “Some of my English friends feel that, in the socialization of England, the deciding votes were supplied by the Conservatives who thought they could safely provide ‘a little socialization.’ The parallel in our country

Thus our efforts to disentangle the agency which supervises our institutions and which they support from the public-housing activities of the Government have come to naught for the time being at least. The consolidation under the National Housing Agency, effected under the war powers given the president and regarded as a temporary expedient to expedite war housing, has now become permanent, until changed or dissolved by act of Congress.³⁹

The phrase “until changed or dissolved by act of Congress,” perhaps displays the League’s resolve to continue the battle for an independent Board with all its previous fervor.⁴⁰ The League’s outlook was not all gloomy. Always pragmatic, League officials pointed out:

We do not feel our fight for the independence of the Federal Home Loan Bank Board has been entirely in vain, however, as the powers given the over-all agency have been much more restricted than those proposed last year and the Board, as such, have been restored, even though it is composed of three, rather than the original five men, with wide and rather vague powers vested in the chairman. It remains for us to adjust our thinking to the situation and cooperate to the best of our ability and do everything possible to develop an understanding of and a sympathetic interest in our aims and objectives.⁴¹

The documents in the investigative report also illustrate a very close relationship between the U.S. League and the Federal Home Loan Bank Board. The chairman of the board, William Divers, apparently made decisions with the industry’s interests and desires closely in mind, and remained open to negotiation with leaders of the industry his board regulated. For example, in a 1949 memo written by League chairman Bodfish to a League lobbyist, Steven Silpher, he states, “Divers is concerned over the branch question and seems anxious to work out some position with us that will give us a more solid and unified front.” Later in the same memo, Bodfish explains that Divers “is already anxious

is clear...” House Select Committee on Lobbying Activities, *Lobbying Activities of United States Savings and Loan League*, 81st Cong., 2nd session, October 31, 1950, 95-96.

³⁹ Ibid., 66.

⁴⁰ Ibid., 65-66; quote from 66.

⁴¹ Ibid., 66.

to ‘go over all this legislation together and see what we can work out.’”⁴² Though Divers engaged in consultation and negotiation with the League, they did not view him as a pushover. For example, in a letter to Bodfish, A.D. Theobald of the League Legislative Committee complained of “Bill Divers’ past performance of slipping out from under like a watermelon seed when you put your finger down on it whenever there is any question of his making a commitment to support legislation...” Whether or not Divers always did what the League wanted him to do, the League’s correspondence with him indicates that he worked closely with them on guiding legislation through Congress.

Documents in the Congressional investigative report also reveal that the League maintained close contact and relationships with key members of Congress, particularly the League’s Executive Chairman Morton Bodfish. The report contains 130 pages of correspondence between the League and legislators, many of whom seem to have close, even affectionate relationships with Bodfish. For example, after Truman’s pocket veto of the FSLIC insurance premium reduction bill in 1946, Bodfish wrote a letter to Representative Spence, a Democrat from Kentucky, and chairman of the House Banking and Currency Committee. He began the letter with, “My Dear Mr. Spence: Your letter of August 26 was greatly appreciated, especially your reassuring statement, ‘We will try again,’ on the insurance premium reduction.” He goes on to say, “But, certainly you did everything humanly possible, at every step of the way, to obtain its enactment into law...” In gratitude for Spence’s help, Bodfish expressed, “I had only favorable reports from the Fifth District as to the progress of the campaign in Kentucky and do not believe you need to be greatly concerned. However, if you feel there is a time when our people can be helpful, you know you have only to send us the word.” Apparently Spence did

⁴² Ibid., 109.

send the word, because prior to the election, Bodfish sent a letter to all League members in Spence's district, reminding them to vote for him, "as chairman of the powerful Banking and Currency Committee, which must pass initially on all bills having to do with finance, housing, or housing credit, he [Spence] has great influence and prestige...He deserves the active support of everyone interested in our thrift and home-financing institutions and their activities."⁴³

Bodfish's friendliness was by no means limited to Democrats like Spence. For example, he enjoyed a very beneficial friendship with Representative Jesse Wolcott, the Republican chairman of the Banking and Currency Committee. The Congressional report contains several letters from Bodfish to Wolcott, including one in April of 1947 thanking the Congressman for introducing four bills sought by the savings and loan industry and asking the Congressman to "find it possible, despite the many and heavy demands upon your time and that of the committee, to get committee approval of these four bills...and advancement to the House floor."⁴⁴

The League did more than simply court Congressmen. It became intricately involved in the drafting of legislation. Abner Ferguson and Horace Russell, the League's attorneys in Washington and Chicago continually drafted legislation to present to friends in Congress. Furthermore, they consulted with these Congressmen on strategy. For example, in January of 1947, Abner Ferguson wrote Morton Bodfish regarding his visit with Congressmen Riley and Spence, and Senator Taft, "I left with Riley and Spence revised drafts of the bills they have introduced and they have suggested that when the bills come up for hearing they ask that the new drafts be substituted for the bills as

⁴³ Ibid., 154.

⁴⁴ Ibid., 165.

introduced.” Besides being skilled drafters of legislation, Ferguson and Russell seemed to be well-connected with members of Congress, visiting them often and sending drafts of bills back and forth. They also testified at Congressional committee hearings when legislation affecting the savings and loan industry was being considered. Interestingly, collaboration on legislation seemed to go in both directions. At least some of the time, Congressmen sought the advice of the League on how to best proceed with pending bills. For example, in a 1947 letter regarding the bill to reduce the premium on deposit insurance, Brent Spence told Morton Bodfish,:

I have introduced the bill as introduced in the last session and subsequently Abner Ferguson brought me a copy of your proposed bill. I told him I thought it would probably be good strategy to submit this bill to the committee when the bill I introduced is considered. However, if you think it would be desirable to introduce the bill as prepared by you, I will be very glad to do so, and will be pleased to discuss the matter with you when you come to Washington.⁴⁵

In another letter to Bodfish regarding a bill on conservatorship, Representative Charles Fletcher asked him to, “Please take a look at the conservatorship bill of Congressman King and let me know what you think at your earliest convenience.” Horace Russell answered the letter for Bodfish, suggesting some changes in the wording and giving the bill his blessing.⁴⁶ The League seemed to play this kind of an active role in all the legislative efforts of this era. Morton Bodfish seemed to be particularly well connected. In a critical Washington Post article about a League dinner, the journalist referred to Bodfish as “ace lobbyist,” and complained that he “managed to corral so many Congressmen for his jamboree that it took 45 minutes to introduce them.”⁴⁷ Bodfish and

⁴⁵ Ibid., 158.

⁴⁶ Ibid.

⁴⁷ Ibid., 56.

the League were well connected and influential, and the legislation they wrote and lobbied for made the business environment very favorable for the industry.

Despite the League's disappointment with the industry's place in the regulatory structure, the postwar decade proved to be a golden age for savings and loans as they enjoyed an unprecedented rate of growth. Free from significant competition, and operating under special conditions, such as freedom to set deposit rates and exemption from much of the income tax, the industry flourished and wrote almost half of all U.S. home mortgages. Furthermore, in 1955, the League finally won its battle to make the Federal Home Loan Bank Board an independent government agency. League Vice President Josephine Ewalt celebrated this success: "A new era of prestige for the savings and loan business and its instrumentalities in Washington was inaugurated by this step. Numerous subsequent developments are traceable to it."⁴⁸

However, all was not perfect. In 1954, the economy experienced a short mild recession that caused many S&L members to withdraw savings. Yet, demand for home mortgages remained high, leaving institutions short on funds. Savings and loans tried to counteract the trend by raising dividend rates and they raised additional money by increasing their borrowings from the Federal Home Loan banks, but the higher rates did not result in retention of funds. Furthermore, in September of 1955, the FHLBB issued a moratorium on advances, arguing that liberal lending by regional banks to members would cause inflation. Thus, the industry faced a credit crunch, which significantly affected growth rates at the end of 1955.⁴⁹

⁴⁸ Josephine Hedges Ewalt, 307.

⁴⁹ David Mason, 160.

1956-1966

While savings and loans did well during the second half of the 1950s and the first half of the 1960s, these years did not prove to be the “golden years” that preceded them. The industry continued to grow, but the return on net worth dropped from its high point of 1955. Furthermore, institutions had to cope with increased competition on both the saving and the lending sides of the business. The industry also became less unified on a number of issues. Disparities in region, size, and form of ownership led associations to pursue different strategies and to take opposing positions on a number of important issues, making it difficult for the League to lobby effectively. The industry and its regulators faced many challenges. Furthermore, changing economic conditions complicated the state of thought about financial sector regulation. In 1961, the Commission on Money and Credit released recommendations based on its 3-year study of the U.S. financial industry. While the study prompted little immediate change, it signaled that change would soon be knocking on the industry’s door.

In terms of growth, savings and loans faced obstacles that they did not encounter during the previous decade. The U.S. economy slowed a bit as manufacturing finally caught up with and satisfied the pent-up demand for goods created during World War II. In fact, these years witnessed three minor recessions in 1954, 1958, and 1961. Production caught up with demand in housing construction as well, with the average annual increase in new housing starts between 1955 and 1965 amounting to a weak .2%.⁵⁰

⁵⁰ David Mason, 159-160; *1966 Savings and Loan Fact Book* (United States Savings and Loan League, 1966) 19.

Savings and loans also faced an earnings squeeze as short term interest rates rose, relative to long term rates between 1961 and 1964. This resulted partly from Kennedy administration and Fed policy aimed at bolstering the dollar in light of a growing balance of payments deficit in the U.S. The higher short term rates encouraged foreign investors to buy Treasury bills rather than turning in their dollars for gold. At the same time, the Kennedy administration sought to encourage long term investment in plants and equipment by keeping long term interest rates low. This combination proved challenging for thrifts, which routinely borrowed short and lent long.⁵¹

In addition, savings and loans met mounting competition from a number of sources. In 1961, James J. Saxon took over as Comptroller of the Currency. Committed to modernizing commercial banking and expanding banks powers, Saxon issued more than 6000 regulations during his tenure. Under him, commercial banks became active participants in the mortgage market, after a change in regulations allowed them to offer loan terms similar to those of savings and loans. By the mid 1960s, commercial banks wrote more than 14% of residential mortgages.⁵² Furthermore, on the savings side, bank regulators took significant steps to help banks compete with S&Ls. Since 1933, the Fed had held the authority to set ceilings on the rates commercial banks could pay on savings under Regulation Q. The ceilings were not particularly important at first because market interest rates tended to stay below the ceiling rate. However, by the 1960s, this was no longer true, and banks began to suffer from disintermediation as depositors moved their funds from savings accounts to other higher yielding investments such as Treasury bonds

⁵¹ Donald D. Hester, "U.S. Banking in the Last Fifty Years: Growth and Adaptation," http://www.ssc.wisc.edu/econ/archive/wp2002-19_4, accessed 12/5/08.

⁵² David Mason, 160-161; "About the OCC: James J. Saxon, Comptroller of the Currency, 1961-1966" <http://www.occ.treas.gov/saxon.htm> accessed 12/10/08.

and commercial paper.⁵³ Bankers urged the Fed to raise Regulation Q limits. In 1965, the Fed responded, setting ceiling rates equal to S&L rates and banks collected 60% of all new savings, while thrifts collected only 19%. Savings and loans, especially those in the Sunbelt states responded with rate increases of their own, and in 1966 a rate war ensued. The Federal Home Loan district banks tried to stop the chaotic competition by refusing advances to institutions that paid deposit rates over 4.25%, however, the effort failed to change behavior. The burden and risk of such fierce competition convinced FHLBB chairman Horne and President Linden Johnson to recommend that Congress pass a bill mandating rate controls for the thrift industry. The League, which was intimately involved in the legislative effort, strongly opposed rate controls, but they proved unable to block them and instead focused on modifying the legislation. The Interest Rate Control Act of 1966 put a ceiling on interest rates that thrifts could pay, but made that ceiling 1/4 % higher than the rate the Federal Reserve allowed banks to pay on deposits—an attractive provision for the S&Ls. The rationale for this privilege related to the special role of S&Ls in housing finance. The rate control law, however, had a one year term and had to be renewed by Congress annually to stay in effect. The law also beefed up the power of the FHLBB by granting it the right to issue cease-and-desist orders when institutions engaged in unsafe practices.⁵⁴

To deal with capital shortages brought about by disintermediation, some banks turned to the Eurodollar market. Created after World War II, the Eurodollar market is the

⁵³ Richard N. Cooper and Jane Little, "Competition and Opportunity," Regional Review, Federal Reserve Bank of Boston, October 3, 2001, www.bos.frb.org/economic/nerr/rr2001/q3/compet.htm.

⁵⁴ David Mason, 160-161, 180-185; Josephine Hedges Ewalt, 315-317; Martin Mayer, 34-36; M. Manfred Fabritius and William Borges, *Saving the Savings and Loan: The U.S. Thrift Industry and the Texas Experience, 1950-1988* (Praeger, 1989) 47-52; Frederick E. Balderston, *Thrifts in Crisis: Structural Transformation of the Savings and Loan Industry*, (Ballinger Publishing Company, 1985) 5.

market for American dollar deposits housed in banks outside the United States. Because regulations for U.S. banks operating outside the country were different from those operating from within, Eurodollar deposits were not originally subject to Regulation Q or reserve requirements. Therefore, banks that were large enough to have foreign branches could work around the regulations, collecting dollars abroad by paying higher rates of interest than regulations would allow them to pay at home. This gave those institutions an advantage over both smaller commercial banks and savings and loans.⁵⁵

During the 1950s, banks and S&Ls also faced minor, though increasing competition for investment capital from mutual funds. After 1940, the Securities Exchange Commission regulated companies offering mutual funds using criteria similar to those used for stocks and bonds. Mutual funds also diversified their investments, making the funds safer. Therefore, on a small scale, investors began to trust such funds with their money, with investments in mutual funds growing at 45% per year during the 1950s. Of course, savings and loans also continued to face competition from the federal government in the form of VA and FHA loans, as discussed above.⁵⁶ Finally, savings and loans competed with each other for savings by offering higher rates of return, or through gifts offered for starting new accounts. Some S&Ls even tried to attract customers by paying dividends more frequently, for example quarterly rather than semi-annually.⁵⁷

Along those lines, perhaps the most significant change during this time was the development of a national market for savings and loan deposits. This occurred because of uneven demand for housing across the country. The rise of the defense industry during

⁵⁵ Richard N. Cooper and Jane Little, "Competition and Opportunity."

⁵⁶ David Mason, 161-163.

⁵⁷ Josephine Hedges Ewalt, 314-316.

and after World War II drew population to the Sunbelt states of the south and west, especially California. Between 1940 and 1960, California's population grew 125%. In Los Angeles, for example, the population grew from 6.9 million in 1940 to 10.6 million in 1950. During the 1950s, the population increased over 54%. The demand for home finance in California skyrocketed, and savings and loans scrambled to fund both perspective homeowners and builders and developers. Since demand far exceeded what regional markets could raise, S&Ls in California began to look for funds outside the region in the 1950s. By 1960, 18.5% of California savings and loan deposits came from outside of the state, and institutions attracted these funds by paying higher rates of return than competing banks and S&Ls.⁵⁸ Advertising in eastern and mid-western newspapers like *The New York Times* and *The Christian Science Monitor*, California thrifts offered higher interest rates than residents of those regions could earn on more local investments. California associations often collected these funds through brokers who charged a 2% commission. In this manner, outside funds financed much of the state's residential development.⁵⁹ By 1960 the FHLB Board passed a regulation limiting brokered deposits at each institution to 5% of total savings present at the beginning of the year.⁶⁰

Deposits did not serve as the only means to move money from east to west. California S&Ls also sold some of their mortgage portfolio to eastern investors. In 1965, for example, California institutions originated about \$3 billion in loans and sold about one fourth of them, mostly to eastern investors.⁶¹ Commercial banks in Arizona used

⁵⁸ Lynne Pierson Doti and Larry Schweikart, "Financing the Postwar Housing Boom in Phoenix and Los Angeles, 1945-1960," *Pacific Historical Review*, 1989; David Mason, 175; Walter J. Woerheide, 7-8.

⁵⁹ Kathleen Day, *S&L Hell: The People and the Politics Behind the \$1 Trillion Savings and Loan Scandal* (WW Norton & Co., 1993) 68; Martin Mayer, 35. Banks offering these investments included Wachovia in North Carolina and Franklin National in New York. Also see Walter J. Woerheide, chapter 1.

⁶⁰ Josephine Hedges Ewalt, 318; Mayer 65-66.

⁶¹ Ned Eichler, 25-26.

similar means to deal with excess demand for mortgages created by their wartime and postwar population boom. For example, one Phoenix firm alone, sold mortgages that it originated and serviced to over 20 investors in the eastern United States. By 1953, these investors had infused over \$30 million dollars into Phoenix area mortgages.⁶²

The fact that California S&Ls procured their funds from outside the region and paid a higher price for them changed the way they conducted business. To be profitable, California institutions had to earn more on their loans. Thus, they tended to charge buyers higher rates of interest. They also sought to write more speculative construction and apartment loans, which generated higher profit than individual mortgages. The state's S&Ls encouraged builders to borrow from them rather than from the FHA and VA in a number of ways, including being more lenient in approval requirements. Many institutions financed builders with little equity or accepted forms of income that the FHA and VA rejected. Some institutions in the state bought land for builders and charged them a small fee to develop that land. In return for lenient requirements, savings and loans collected large fees. The state's S&Ls derived twice as much of their income from fees as institutions in other states. In pursuing higher yielding investments, California institutions suffered a much higher rate of loan delinquencies, which rose for the entire industry during the early 1960s. However, in California, the rate grew at 60% per year as compared to 35% per year for the rest of the industry. Furthermore, S&Ls in California tended to be larger than in other states. California savings and loans averaged \$100 million in assets, as compared to the average in the rest of the nation of \$20 million. Some institutions grew to be very large. Within the state of California, the ten largest savings and loans possessed 44% of S&L assets. The three largest firms controlled 30%

⁶² Lynne Pierson Doti and Larry Schweikart, 180-181.

of the total. The state also housed the two largest S&Ls in the country, which each had over \$2 billion in assets. No other institution in the U.S. had acquired even \$1 billion in assets.⁶³

Such vast differences in size, location, and manner of doing business created divergent interests within the industry. Managers of smaller savings and loans disliked the high interest rates offered by large institutions in California and other Sunbelt states.⁶⁴ In an era of increasing consumer awareness of deposit rates, smaller institutions had no choice but to compete with those rates or lose deposits themselves. Furthermore, some associations, particularly those in the Sunbelt, who faced higher mortgage demand than they could meet, wanted to change their ownership structure from mutual to stock in order to raise funds. Though federal savings and loans were required to use mutual ownership until 1976, many states began to allow their chartered institutions to convert to stock ownership. California was the first, with 23 states following suit by 1967. As a result, savings and loan holding companies began to develop, creating controversy within the industry. Many felt that holding companies presented a conflict of interest, since they could own other savings and loans or financial institutions that competed with each other. Those against stock ownership also argued that publicly-owned institutions would forget their original mission to benefit members of the local community and would instead look for high-yielding, but riskier investments to earn lofty profits for investors. The larger, southwestern, stock-owned associations increasingly held different opinions about the industry's future and this lack of industry unity made it difficult for the League to lobby

⁶³ Ned Eichler, 24-29.

⁶⁴ Federal Home Loan Bank Board Chairman James McMurray did not like the higher rates either. To discourage the paying of such high dividends, he formed a new FSLIC reserve that required each institution to pay in 2% of their insured savings. Later, he linked the reserve requirement to total asset growth, making reserves most burdensome for fast-growing institutions. See David Mason, 178-182.

Congress effectively. Particularly awkward and difficult was the fact that the large California S&Ls possessed so much wealth and thus immense political power.⁶⁵

The increasing complexity of the U.S. financial sector, growing competition among financial intermediaries, and problematic trends in the U.S. economy such as a slower growth rate, lack of sensitivity in price levels, and rising unemployment led to the formation of the Commission on Money and Credit in 1957. The Committee for Economic Development (CED), a nonpartisan, non-profit public policy group, had suggested that Congress form such a commission to undertake a broad study of the U.S. financial system in 1948 and again in 1951. However, Congress did not appropriate the funds. In his 1957 State of the Union Message, President Eisenhower also asked Congress to authorize such a commission, composed of members of Congress and private citizens. When Congress again failed to provide funding, the CED funded the study itself, along with the Ford and Merrill Foundations. In addition to financial intermediaries, the commission studied several wide-ranging economic issues such as fiscal and monetary policy, public and private debt, and taxes. Its membership represented a broad spectrum of expertise, including 8 members who already served on the Council for Economic Development, 10 members from the financial industry, and 3 union officials. After 3 years of intense study and information-gathering, the commission published its report in 1961.⁶⁶

⁶⁵ David Mason, 175-177; Walter J. Woerhide, 13.

⁶⁶ Robert Z. Aliber, "The Commission on Money and Credit, Ten Years Later," *Journal of Money, Credit and Banking*, Vol. 4, No. 4. (Nov., 1972) 915-929, <http://www.jstor.org/stable/1991234> accessed 12/1/07; Karl Brunner, "The Report of the Commission on Money and Credit" *The Journal of Political Economy*, Vol. 69, No. 6 (Dec., 1961) 605-607, <http://www.jstor.org/stable/1828352> accessed 12/1/07; *Money and Credit: The Report of the Commission on Money and Credit, Their Influence on Jobs, Prices, and Growth* (Prentice Hall, 1961).

According to commission member Robert Aliber, the report represented a new way of thinking about financial regulation. Prior to this, he argues, regulators gave little consideration to how regulation of one type of financial intermediary affected others. This report, on the other hand, looked at the position of the various intermediaries -- commercial banks, mutual savings banks, and savings and loans -- relative to each other. "The Commission in effect accepted a general equilibrium view of the financial structure and sought a rational structure for the relationship among intermediaries." Committee recommendations, Aliber argues, more closely reflected philosophy than empirical study. They included the suggestion that financial intermediaries be made more similar in function and regulation. The commission encouraged the elimination of interest rate controls and leniency in branching restrictions for all types of institutions. However, the final report did warn that regulators should continue to limit investment options for thrifts—savings and loans and savings banks—to avoid risk.⁶⁷ The study conducted by the Commission on Money and Credit signaled the need to adjust to changing economic conditions. President Kennedy and his administration received the report favorably, but no immediate legislation was passed. However, the report remains a testimony to the fact that by the 1960s, experts understood that to remain healthy, the financial industry would have to be at least partially deregulated.

1967-1978

During the late 1960s and 1970s, savings and loans faced numerous challenges and obstacles in an increasingly complex and difficult economic environment. The U.S. economy entered its first troubled era since WWII. Interest rates, which had remained relatively stable since the New Deal rose considerably during the 1970s, making it

⁶⁷ Robert Z. Aliber, 921-927, quote from 926.

difficult for S&Ls to attract funds and raising the cost of funds they did collect. New financial instruments wooed depositors away from their local savings and loans, which were limited in how much interest they could pay under Regulation Q. Three major studies of the industry were conducted during this time, and deregulatory recommendations did find their way into legislative bills, but consensus proved illusive, and none of the measures passed. While the FHLBB took some actions to solve the industry's problems, a far-reaching solution was not yet implemented.

The problems that converged on the U.S. economy in the early 1970s involved global forces that had been building for some time. The mass production, mass consumption mode of production that had brought about such a long era of prosperity began to falter. As Japan and Germany rebuilt their economies American style, their products began to compete with those of American manufacturers. Mass production at home and abroad finally satisfied the exceptionally high post-war demand for consumer goods and world markets became saturated. Economic growth proceeded slowly during these years, with recessions taking place in 1969, 1974-5, and 1979. In addition, by the late 1960s, decades of booming economic growth combined with high government spending on both the Vietnam War and Great Society programs triggered inflation. By 1966, the price level had risen by almost 3%. In 1970, prices rose by more than 5%. The oil embargo of 1973, which caused a steep increase in the cost of oil, had inflationary reverberations throughout the economy making the situation much worse. Thus, the term stagflation entered the American vocabulary, referring to the problematic combination of slow growth and high price levels. By 1971, inflation had so eroded the value of the American dollar that the Bretton Woods system of fixed exchange rates collapsed as

Richard Nixon took the U.S. off the gold standard. Rising interest rates plagued the economy, caused partly by government deficit spending, but also used by the Federal Reserve as a tool to control inflation and in a last ditch effort to salvage the Bretton Woods system. Mortgage rates, at 5% during the mid 1960s climbed to 8.5% by 1970 and to 11% by 1978.⁶⁸

The U.S. economy underwent a period of profound adjustment to cope with these changes. The new system that emerged was characterized by a shift in production from manufactured goods to services; the development of a large array of new financial instruments that created profits without production; a restructuring of labor to provide greater flexibility, including moving production to regions with lower labor costs; and enhanced concentration of economic power. Technological innovation also played a large role in this adjustment. For example, corporations could move facilities to other regions and even other countries because developing computer technology made it easier to track and coordinate their activities across vast distances.⁶⁹

The new conditions, however, posed several problems to savings and loans. First, rising interest rates made it difficult for them to attract and retain funds. From 1969 through the 1970s, market interest rates periodically climbed higher than the maximum rate S&Ls could offer under Regulation Q. When this happened, depositors, often aided by new technology, moved their funds to investments that paid higher rates. This

⁶⁸ Norman Strunk and Fred Case, 1-2; Martin Lowy, *High Rollers: Inside the Savings and Loan Debacle*, (Praeger, 1991), 2-3; Paul Zane Pilzer with Robert Deitz, *Other People's Money: The Inside Story of the S&L Mess* (Simon and Schuster, 1989) 59-60; David Mason, 188; David Harvey, *The Condition of Postmodernity: An Inquiry into the Origins of Cultural Change* (Bais Blackwell, 1990) 126-136; Frederick E. Balderston, 4-5; Donald D. Hester, 7-8.

⁶⁹David Harvey, *The Condition of Postmodernity*, 157-160; Donald D. Hester, 8-12, Mike Davis, *Prisoners of the American Dream: Politics and Economy in the History of the U.S. Working Class* (Verso, 1986) 129-137; Also see Barry Bluestone and Bennett Harrison, *The Deindustrialization of America: Plant Closings, Community Abandonment, and the Dismantling of Basic Industry* (Basic Books, Inc. 1982); Jefferson Cowie, *Capital Moves: RCA's Seventy-Year Quest for Cheap Labor* (Cornell University Press, 1999).

fluctuation in deposit levels created instability and made it difficult for financial institutions to plan for the future.⁷⁰ This problem became especially severe in the early 1970s with the launching of a new investment instrument, the money market mutual fund. A cash management firm called The Reserve takes credit for creating the first money market mutual fund in 1970. By 1971, these instruments came under SEC regulation.⁷¹ Money market funds collected and pooled private savings, and invested in Treasury bills, high-quality commercial paper, and large denomination certificates of deposit. Investors had the ability to access their funds without penalty by writing a limited number of checks each month, known as negotiable orders. Though these accounts were not technically backed by the full faith and credit of the U.S. government, their conservative investment portfolios tended to be safe, and consumers took to them immediately. These funds became a major source of competition for consumer savings. By 1979, money market funds claimed 13.5% of total U.S. savings, with \$42.9 billion in assets; and by 1982, these funds held over \$230 billion in assets.⁷²

The banking and thrift industries urged regulators to allow them to compete with the higher yielding investment options. In 1973 regulators allowed financial institutions to offer \$1,000 four year certificates of deposit (CD) with no rate ceilings. However, these instruments created chaos as rate wars among institutions arose, and were quickly banned. In 1974, institutions began to offer a new type of CD with a much shorter term, but it required a minimum investment of \$100,000, thereby discriminating against the small saver. Finally, in 1977 associations were permitted to offer the money market

⁷⁰ Donald Hester, 9-10.

⁷¹ "About the Reserve: A Tradition of Financial Innovation" <http://www.reservefunds.com/history.shtml>, accessed 6/17/2008.

⁷² Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation* (Oxford University Press, 1991) 69.

certificate. This investment could be bought in \$10,000 denominations and the interest rate rose and fell with the rate of the 6-month Treasury bill. While this instrument did succeed in attracting funds, it led to a significant increase in the cost of funds. Often S&L members moved money from ordinary savings accounts to these higher yielding options. By 1978, 75% of savings for the industry took the form of accounts that paid market rates of interest.⁷³

Financial institutions in some states tried to answer the challenge posed by money market mutual funds with Negotiable Order of Withdrawal or NOW accounts. NOW accounts paid interest on savings, yet like money market funds, NOW accounts allowed depositors to write a limited number of checks per month to access their funds. NOW accounts pushed the regulatory envelope, since banks had been prohibited from paying interest on demand deposits since the New Deal.⁷⁴ However, Congress allowed them in Massachusetts and New Hampshire as an experiment, regulated by the FDIC. In 1973, Congress authorized federal S&Ls in states that allowed NOW accounts to offer them as well. By 1976, Congress permitted NOW accounts in all the New England states.⁷⁵

In this environment of high interest rates, savings and loans also turned to the secondary market to raise funds. Mortgage originators had the option to sell to Fannie Mae since its creation in 1938, and in 1968, the government created the Government National Mortgage Association (GNMA), typically known as Ginnie Mae. Ginnie Mae helped institutions bundle pools of FHA and VA mortgages, added their own guarantee,

⁷³ David Mason, 190-191; Frederick E. Balderston, 5-7, 56; R. Dan Brumbaugh, Jr., 14-15; Andrew S. Carron, *The Plight of the Thrift Institutions* (The Brookings Institution, 1982) 8-9.

⁷⁴ David Mason, 194.

⁷⁵ House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing, *Consumer Financial Services Act of 1977 (NOW Account Legislation)*, 95th Congress, 1st session. September 7, 1977, 40.

and sold shares in these packages. The purchaser of Ginniemaes bought a share of the pool, and collected a corresponding share of the payments made by homeowners. The profit to investors in the pool depended on factors such as how long homeowners kept their mortgages before selling or refinancing. Each pool performed slightly differently and was heavily influenced by the movement of interest rates.⁷⁶

The Emergency Home Finance Act of 1970, signed into law by President Richard Nixon, offered another secondary market option with the creation of the Federal Home Loan Mortgage Corporation or Freddie Mac. Freddie Mac was originated to buy conventional mortgages, specifically from savings and loan institutions. It tapped into investment funds by selling “pass through” mortgage paper or income streams. Income stream investments allowed the purchaser to buy only segments of a bundle of loans, depending on specific investor needs. For example, investors could buy principle-only segments, meaning they would receive payment as homeowners paid on their principle loan amounts. These payments tended to be delayed since homeowners paid mainly interest during the early years of a mortgage loan. Interest only segments paid investors out of homeowner interest payments, and tended to pay earlier. Fluctuations in interest rates affected these investments as well. For example, a drop in rates would cause homeowners to refinance and thus pay off principle.⁷⁷

The rise of a national secondary mortgage market, which used investor funds to finance mortgages, drastically changed the landscape of the home finance market. Throughout the 1950s, 1960s, and 1970s, 25-30% of originated mortgages were sold on

⁷⁶ Martin Mayer, 38-39; David Mason, 191.

⁷⁷ Martin Mayer, 41; David Mason, 191; M. Manfred Fabrituius and William Borges, 59.

the secondary market.⁷⁸ This brought an enormous amount of new capital into the home mortgage business and brought investment firms into the process. For savings and loans, this proved to be a mixed blessing. While the secondary market gave thrifts an alternative method of raising capital for home loans, it also encouraged competition and challenged their position of privilege. With agencies such as Fannie Mae and Freddie Mac collecting vast amounts of investor capital and making it available for home mortgages, savings and loans became a less vital component of the housing finance market. With the ability to sell mortgages quickly, and with the security of private mortgage insurance, which became widely available after the 1960s and 1970s, commercial banks sought to compete directly and “entered the mortgage business with a vengeance.”⁷⁹ Saving and loan institutions originated to fill a void in the banking marketplace. By about 1980, that void was shrinking. As Berkeley economist and builder, Ned Eichler, explains, “When anyone could originate loans and sell them to the agencies and other conduits, or even set up his own channel, the ability to acquire deposits, aided by government insurance, was of little, if any, benefit.”⁸⁰

The industry also struggled during this era because it became more difficult for families to afford their homes. With interest rates reaching new heights, monthly payments often exceeded borrowers’ ability to pay, which prompted the development of new mortgage products, known as alternative mortgage instruments (AMI). AMIs lowered initial monthly payments by offering features such as interest only payments for the first five years or graduated payments that increased at given intervals. While these loans helped people get into homes, they often produced negative side effects. With

⁷⁸ R. Dan Brumbaugh, Jr., 163-166.

⁷⁹ Kathleen Day, 58-9.

⁸⁰ Ned Eichler, 45-49.

AMIs, borrowers did not accumulate equity in their properties for the first several years of ownership, and when payment amounts rose, borrowers sometimes could not afford the new payment. Other types of AMIs helped deal with changes in interest rates by offering below market rates at the start of the loan that increased at intervals during the loan period, or pegged the rate to an index such as the rate for 6-month Treasury bonds. However, variable rate mortgages proved risky because monthly payments could increase too rapidly for the buyer to afford. Regulations prohibited federally chartered S&Ls from using them and California alone allowed its state-chartered institutions to use these during this era.⁸¹

The instability of interest rates made it difficult for S&Ls to maintain their levels of mortgage lending and squeezed profit margins. During periods of high interest rates, such as 1969-70, and 1973-4, savings and loans found themselves paying high interest rates to raise the funds demanded in the housing market, yet they derived their income almost solely from a portfolio of mortgages written in the past at lower rates of return. Institutions could either pay more for funds, or fall short of satisfying mortgage demand. "Thus, in a period of rapidly rising rates, the thrift institutions faced an earnings squeeze if they raised offering rates and a liquidity squeeze if they did not."⁸² In addition, federal regulations prohibited savings and loans from diversifying their investment portfolios or from offering adjustable rate mortgages that transferred all or some of the interest rate risk to borrowers.⁸³ Federal regulation that privileged social goals over economic

⁸¹ David Mason, *188-189*; For more on alternative mortgage instruments, see Walter J. Woerhide, *The Savings and Loan Industry: Current Problems and Possible Solutions* (Quorum Books, 1984) chapter 4.

⁸² Memorandum from Robert Carwell to Regulation Q Task Force, October 6, 1978, Council of Economic Advisors, Regulation Q, Box 74, Charles L. Schultze's Subject Files, Jimmy Carter Presidential Library.

⁸³ R. Dan Brumbaugh, Jr., 15-20.

rationality threatened to let the industry down and the need for deregulation became obvious.

In 1966, in response to the industry's problems, Congress authorized an in-depth study of the savings and loan industry. The FHLBB commissioned Dr. Irwin Friend of the Wharton School of Finance and Commerce to conduct the study, along with scholars from universities across the country. Three years later, the final report, often referred to as the "Friend Report," was presented to the FHLBB. Friend claimed that the study, which included 20 separate scholarly papers, represented "the most comprehensive analysis of the savings and loan industry which has ever been undertaken."⁸⁴

The final report recommended significant, but cautious deregulation of the industry. On the asset side, the study suggested an expansion of powers for S&Ls, including the right to offer consumer credit and mortgages on multi-family residences. However, the panel did suggest limiting non-real estate loans to 10% of association assets. On the liability side, the report suggested that S&Ls be permitted to offer savings accounts with varying maturities, capital notes or debentures, and limited checking privileges for its customers. The report also counseled that interest rate ceilings for S&Ls and their competitors should be gradually eliminated "in a period when credit is easy and market interest rates are declining appreciably." Regulating agencies, however, should have "the standby power" to reinstate the ceilings if necessary.⁸⁵

In terms of regulations, the study suggested that liquidity requirements be kept flexible, so that they could be lowered "under appropriate circumstances (particularly to

⁸⁴ Irwin Friend, "Summary and Recommendations: A part of the Study of the Savings and Loan Industry" in *Study of the Savings and Loan Industry, Prepared for the Federal Home Loan Bank Board* (U.S. Government Printing Office, 1969) 1-3. Quote from Letter of Transmittal from Irwin Friend to Preston Martin, July 31, 1969, in *Study of the Savings and Loan Industry*, III.

⁸⁵ Irwin Friend, "Summary and Recommendations," 29-30.

meet net withdrawals).” Capital requirements, the experts advocated, should vary with the potential risk of an association’s investment portfolio. The report also recommended a loosening of branching restrictions in order to provide for more competition and for efficiency through economies of scale. Finally, the study recommended that federal S&Ls be permitted to convert to stock associations, under certain guidelines that would allocate “conversion profits among parties at interest,” including perhaps having FSLIC or the federal government receive some of the proceeds. Finally, in terms of supervision and examination, the study suggested that regulators use statistical data to identify troubled institutions and thus monitor them more frequently and carefully than other institutions.⁸⁶

The study also prescribed that the FHLBB make expansion loans to associations during “periods of tight money,” or to associations in areas where mortgage demand clearly exceeds the funds that can be raised “(except at rates which are clearly excessive in relation to the cost of financing in the rest of the country).” However, advances should be offered only to sound institutions, the report warned.⁸⁷ Though the Friend report enjoyed the full support of the U.S. League, it did not result in any legislative proposals or regulatory change during this time.⁸⁸

In 1969, as the economy and the savings and loan industry continued to deal with the problems of rising interest rates, inflation, and unemployment, the President’s Commission on Financial Structure and Regulation, also known as the Hunt Commission, after its chairman Reed Hunt, began its study of the U.S. financial market. Commissioned by Richard Nixon, the group took a neo-liberal viewpoint that

⁸⁶ Ibid.

⁸⁷ Ibid.

⁸⁸ David Mason, 206.

government regulation hindered the efficiency of free markets. In general, the commission believed that the barriers between various kinds of financial institutions should be removed on both the liability and asset sides, and that they should become more alike. Along these lines, the commission advocated phasing out the differential on interest rate ceilings over a 5 year period. After that time, all financial institutions would be subject to the same rate ceilings. Rate ceilings overall should be phased out, the 1972 report argued, so that financial institutions could compete with money market funds for deposits. For 10 years, the Fed should retain the authority to use rate ceilings, but only when a threat of serious disintermediation existed. Furthermore, the report suggested that all institutions be allowed to offer demand deposits and be subject to the same reserve requirements and taxation.⁸⁹

On the asset side, the commission recommended that S&Ls be allowed to diversify by offering credit cards, holding subordinated debt, and selling mutual funds. Banks, the commission suggested, should continue to enter the mortgage business, with all financial institutions being taxed similarly. Barriers against branching and interstate banking should be removed, argued the commission, and the Glass-Steagall wall between banking and securities should be eased. Finally, the report suggested a partial consolidation of financial industry regulation, paring down the number of regulatory agencies to two or three. Separate agencies might exist, the report suggested, for

⁸⁹ George J. Benton, "Discussion of the Hunt Commission Report: Comment" *Journal of Money, Credit, and Banking* Vol. 4, No. 4 (November, 1972) 985-989, <http://www.jstor.org/stable/1991238> accessed 11/11/08; Roland I. Robinson, "The Hunt Commission Report: A Search for Politically Feasible Solutions to the Problems of Financial Structure" *The Journal of Finance* Vol 27, No. 4 (September 1972) 765-777, <http://www.jstor.org/stable/2978667> accessed 11/7/07.

federally chartered institutions and for state chartered institutions who the federal government insured. Then, a third agency might oversee federal deposit insurance.⁹⁰

Two pieces of legislation attempted to implement some of these recommendations. The Financial Institutions Act of 1973 included a phase-out of Regulation Q, a provision to allow thrifts to offer NOW accounts, and also authorization for thrifts to invest up to 10% of assets in consumer loans. To encourage S&Ls to continue their specialization in mortgages, the bill also offered tax credits on real estate loans. The League however opposed the bill because of the provision phasing out Regulation Q. Though thrifts strongly opposed interest rate ceilings when they were implemented in 1966, over time the industry came to support the ¼% advantage over commercial banks that they received and they supported its renewal annually even though it made it virtually impossible for S&Ls to compete with money market funds for consumer deposits. The lack of League support prevented this bill from passing.⁹¹ The Financial Institutions Act of 1975 proposed similar changes except it allowed S&Ls to diversify assets even further by holding up to 30% of assets in consumer loans and commercial stock. Again the League opposed the measure because of its phase-out of Regulation Q. Though the bill passed the Senate, it failed in the House.⁹² Economist, Roland Robinson, has argued that the Hunt Commission tried to recommend politically feasible reform, but they apparently were not feasible enough, since none of the suggested changes made their way into legislation for more than 5 years.⁹³

⁹⁰ Lester V. Chandler and Dwight M. Jaffee, "Regulating the Regulators: A Review of the FINE Regulatory Reforms, *Journal of Money, Credit and Banking*, Vol. 9, No. 4 (Nov., 1977) 627 <http://www.jstor.org/stable/1991535> accessed 9/17/07; Susan Hoffman, 229-230; David Mason, 207-208;

⁹¹ David Mason, 207-208.

⁹² Ibid.

⁹³ Roland I. Robinson, 767.

In 1975, Representative Ferdinand St. Germain, Chairman of the House Committee on Banking, Finance, and Urban Affairs took the unusual action of calling for a new study to be conducted, which came to be known as the Financial Institutions and the National Economy Study, or Fine. According to FINE study director, James Pierce, “Most legislation is developed outside of Congress by the administration, by independent agencies, by special commissions, or by special interest groups. Congress normally reacts to these legislative proposals, modifies them, and then votes them up or down.” However, in this case, the Banking Committee was dissatisfied with several years’ worth of financial reform proposals and thus turned to this procedure instead.⁹⁴ The report repeated many of the same recommendations of past studies, such as eliminating Regulation Q, which Pierce referred to as “without social redeeming value.” The FINE Discussion Principles also advocated permitting all depository institutions to offer demand deposit accounts and subjecting them to equal reserve requirements. In order to encourage investment in housing, reserve requirements would be lowered, based on an association’s volume of low and moderate income mortgage loans.⁹⁵

The study also made some suggestions considered radical. For example, it advised that all the regulatory agencies—the Comptroller of the Currency, the FDIC, the Fed, the FHLBB, and the NCUA—be combined into a single agency, the Federal Depository Institutions Commission. Depository institutions had become quite similar, and were bound to become more similar with future reforms, the study argued. Thus, it would not make sense to have them regulated and supervised by 5 different agencies.

⁹⁴ James L. Pierce, “The FINE Study,” *Journal of Money, Credit and Banking* Vol. 9, No. 4. (Nov., 1977) 606.

⁹⁵ House Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearings, *Financial Institutions and the Nation’s Economy (FINE) “Discussion Principles”* 94th Congress, 1st and 2nd sessions, Part I, December 2, 1975, 3-8.

Furthermore, Pierce explained, the Federal Reserve should be separated from its supervision of banks and allowed to concentrate on its role of formulating monetary policy. In that policy formation role, however, the Fed needed to become much more subject to Congressional scrutiny, since monetary policy was so important:

Monetary policy, on the other hand, is determined in secret by a group of men who are, not even elected. Furthermore, the Federal Reserve Banks presidents, who cast 5 out of the 12 votes on the Federal Open Market Committee, which is the most important policymaking body within the Fed, do not even receive Presidential appointments. Yet the decisions at the Fed can undo fiscal policy. Those who decide monetary policy have the potential of choosing between prosperity and depression; between inflation and price stability; between financial stability and instability. In short, they have tremendous power but they are accountable to no one.⁹⁶

Not surprisingly, these more radical recommendations of the Fine report such as the attack on Fed power, became hotly contested and did not make it into the next attempt at financial reform, The Financial Reform Act of 1976. The main difference between this bill and the previous two lay in the phase-out of the housing differential in interest rate ceilings. While the bill called for a 5-year phase-out like the ones before it, it stipulated that S&Ls holding more than 80% of their assets in home mortgages be allowed to maintain their ¼% differential. The bill, however, never made it out of committee. “It became abundantly clear in the hearings that the vehement opposition by some influential groups could not be offset by the support of other groups and that the bill could not be passed. As a result FIA was allowed a peaceful death,” explains Pierce.⁹⁷

In the absence of any new legislation, the FHLBB and other regulators took several actions in the 1970s to try to solve industry problems. In 1972, the Board adjusted reserve requirements, making it easier for institutions to comply. On the

⁹⁶ Ibid., 8.

⁹⁷ David Mason, 208-209; Lester V. Chandler and Dwight M. Jaffee, “Regulating the Regulators,” 627; Quote from James L. Pierce, “The Fine Study,” 606.

liability side, the Board increased the products thrifts could offer savers outside of the restrictions of Regulation Q rate ceilings, including permitting the creation of money market certificates in 1978. These certificates, which had a maturity of 26 weeks, required a minimum investment of \$10,000 and pegged interest rates to the 26-week Treasury bill, giving thrifts a differential over commercial banks. In 1979, regulators authorized both banks and thrifts to offer a new financial instrument, the Small Saver Certificate, beginning in January of 1980. These certificates had no minimums, matured in 30 to 48 months, and indexed their rate ceilings to the average 2 1/2 year rate paid for U.S. Treasury bills. Again, thrifts were awarded a differential.⁹⁸ The FHLBB in concert with the Federal Reserve also raised rate ceilings throughout the decade, making savings accounts at least a bit more competitive with other investment alternatives. On the asset side, the Board increased the maximum loan to value ratio that S&Ls could offer on construction loans, and allowed them a larger geographic lending area in which to do business. These measures proved small, however, and the kind of long term, extensive reform that the regulatory system so badly needed, did not happen.⁹⁹ In fact, by 1975, Economics professor Edward J. Kane, witness before the House Subcommittee on Financial Institutions, suggested that actions such as these had hurt more than they helped:

During the last 15 years, a succession of commissions and study groups have taken up this issue, but with no palpable benefits. In fact, instead of developing benefits, things have gotten worse. Financial incentives have

⁹⁸ E. Gerald Corrigan and Evelyn Carroll, "Meeting Challenges of a New Banking Era," *1981 Annual Report Essay* Federal Reserve Bank of Minneapolis; Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, Hearing, *Depository Institutions Deregulation Act of 1979, Part II*, 96th Congress, 1st session, June 27, 1979, 92-93.

⁹⁹ M. Manfred Fabritius and William Borges, 59-69.

been distorted, and the whole financial system has been made more fragile by what I regard as ill-conceived, patchwork adjustments.¹⁰⁰

The Comptroller of the Currency made a similar point when testifying before the Senate Subcommittee on Financial Institutions in June of 1979. Regulatory actions could not adequately respond to the challenges facing financial institutions, argued Cantwell Muckenfuss, Senior Deputy Comptroller of the Currency. In fact, he explained that some institutions feel that jerry-rigged solutions to the deposit rate ceilings “could threaten the solvency of a number of institutions. These concerns demonstrate the dangers and problems that the substitution of regulatory judgments, regarding appropriate deposit rates and deposit conditions, for the decisions of competing financial institutions leads to.”¹⁰¹

The question to be explored is “Why?” Based on the studies addressed above, executive agency regulators such as the FHLBB and the FDIC, key members of Congress such as the Chairman of the House Banking Committee, industry associations such as the U.S. Savings and Loan League, and members of the financial industries themselves all seemed to be aware of an acute need for financial deregulation.¹⁰² They could see the wave of potential problems drifting in towards their industries if something was not done to change the tides. Yet, no consensus could be reached. Part of the problem, explained

¹⁰⁰ House Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation, and Insurance, *Financial Institutions and the Nation's Economy (FINE) 'Discussion Principles'* Hearings 94th Congress First and Second Sessions, 1975, 112.

¹⁰¹ Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Financial Institutions, Hearing, *Depository Institutions Deregulation Act of 1979, Part II*, 96th Congress, 1st session, June 27, 1979 94-95.

¹⁰² Testifying before the House Subcommittee on Financial Institutions, Economics professor, William Silber even commented, “It is somewhat unique to find economists, politicians and businessmen in general agreement on anything, much less the need to reform the existing institutional structure. This is, indeed, the situation with the regulatory environment surrounding the deposit institutions and the markets in which they operate.” House Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Financial Institutions and the Nation's Economy (FINE) 'Discussion Principles'* Hearings, 94th Congress, 1st session, 1975, 131.

FINE study director, James Pierce, involved the belief by each industry group involved, that deregulation would result in loss of benefits for them. As discussed above, in the case of S&Ls, the biggest reservation involved losing the advantages bestowed upon them by the housing differential of Regulation Q. Economics professor Franco Modigliani, explained to the House Subcommittee on Financial Institutions:

...some in the industry may say that they want to see the ceiling eliminated eventually, I think it is lip service. I completely agree with you that when they are absolutely honest they want that protection; they don't want any competition ... You know perfectly well that nobody wants competition except everybody else. Everybody else should be competing, but I should be protected. I think that industry feels very strongly in that direction, but should you as legislators approve that?"¹⁰³

Also, Pierce argued, regulated institutions had become comfortable with their regulators and felt uncertain about what the future would bring if consolidation of agencies occurred. Regulating agencies, for their part, tended to be bureaucratic institutions with an interest in protecting their turf, and therefore had no desire to be consolidated into one super-agency.¹⁰⁴ Ironically, lobbyists representing the various interest groups faced the same issue. Consolidation might lead to a loss of work for them.

Another problem involved the lack of a crisis at this point in time. Clearly, S&Ls and other financial institutions faced hard times and challenges from the economic troubles of the 1970s. However, despite the challenges, the savings and loan industry managed to increase assets and profits during this time period. In fact, by 1978, net income as a percentage of net worth, which had declined for the industry from 1955 to 1967, and had fluctuated from 1967 to 1978, returned almost to the 1955 level.¹⁰⁵ While,

¹⁰³ Ibid., 209.

¹⁰⁴ James L. Pierce, "The Fine Study," 616.

¹⁰⁵ Ned Eichler, 40-41.

problems may have been on the horizon, they had not arrived yet, and since legislation hinged on agreement by multiple groups that had much to lose or gain—commercial banks, S&Ls, mutual savings banks, credit unions, money market brokers—consensus was unlikely to occur without a crisis. No crisis existed yet, and unfortunately, no wide-scale changes would be made to U. S. financial regulation during this era.

Between World War II and the late 1970s, the experience of the financial regulatory structure set up by the New Deal ranged from unquestionable success to struggle. The fate of the industry somewhat mirrored that of the economy overall. The golden years of the post-war decade gave way to good solid years during the 1950s and early 1960s. But, by the late 1960s and 1970s, the economy and the savings and loan industry experienced great change and the terms of doing business became much more complicated and difficult. The political system responded attentively to the needs of the industry during the 1940s and 1950s, helping to make it the major source in home financing that it became. By the late 1960s and 1970s, it became less clear how the government could help S&Ls. Indeed, it became less clear to the industry how it could help itself. Furthermore, the development of a myriad of new financial instruments to raise funds for home finance began to call into question the special role the government had assigned to the savings and loan industry.

The unfortunate part of the story is that the flaws in the New Deal system made savings and loans extremely vulnerable to interest rate fluctuation. The New Deal did indeed create “an accident waiting to happen.” Institutions that did everything the federal government asked of them found they had a problem in the 1970s. Even more unfortunately, the executive and legislative branches of government and industry leaders

proved unable, or perhaps unwilling to solve this problem through regulatory reform before it reached crisis proportions. This failure calls into question the ability of U.S. democracy to solve economic problems effectively.

CHAPTER 3

DEREGULATION: THE RESTRUCTURING OF THE NEW DEAL REGULATORY SYSTEM

The legislative process leading to the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) was long, and the story of how a supportive coalition was finally built around this deregulatory legislation is complex. Efforts to reform the banking system had failed for almost a decade. They succeeded in 1980 because of an exceptional confluence of economic and political circumstances. On the one hand, technological change that allowed money to move more quickly than ever before, both within and outside of the country fundamentally challenged the regulatory framework of U.S. banking. This practically forced Congress to address the issue of financial reform. At the same time, troubling economic conditions of the late 1970s made it clear that without remedial action, a banking crisis was imminent. This all happened to take place while the White House was occupied by a president uncommonly willing to take on politically difficult legislative issues such as deregulation. Together, these factors created a rare moment when legislation that asked all interested parties to compromise could pass.

Jimmy Carter was an unlikely prospect for U.S. President. Not only was he a Washington outsider, but he lacked all desire to become a Washington insider. He disliked the special interests that dominated U.S. politics, believing that they interfered with the government's obligation to pursue the public interest. He also opposed the pork barreling, partial solutions, and unsatisfying compromises that represented the usual

mode of operation in Congress. However, the public's disillusionment with government following the Watergate scandal, and a 16-month recession during Ford's administration that caused unemployment to linger at 7.8% at the time of the November, 1976 election, allowed an outsider like Carter to carve a space for himself in presidential politics. Thus, Carter took office in 1977, determined to tackle the kind of difficult and politically unattractive issues that most politicians preferred to ignore.¹

The tasks that lay before Carter were less than glamorous. He assumed the presidency during difficult times that were not of his making. The economy was still struggling to recover from the 1973-5 recession, with unemployment above 7%. Slow growth, however, did not provide much relief from a problematic level of inflation, just below 6%. At the same time, Carter, a fiscal conservative, inherited a \$66 billion budget deficit.² During his campaign, Carter promised to achieve a balanced budget by the end of his first term and to make full employment a top priority. Upon entering office, this President, who asked the head of his Domestic Policy Staff to compile a list of all promises he made during the campaign, tried to make good on these commitments. He pushed a stimulus package through Congress, attempting to speed up recovery from the recession. It included tax cuts for individuals, tax credits for businesses that hired new employees, a multi-faceted jobs program, and an increase in counter-cyclical relief for state and local governments.³

¹ Charles O. Jones, "Carter and Congress: From the Outside In" *British Journal of Political Science* Vol. 15, No. 3 (July 1985) 270 <http://www.jstor.org/stable/193695> accessed 3/25/08; William F. Grover and Joseph G. Pescheck, "The Rehabilitation of Jimmy Carter and the Limits of Mainstream Analysis" <http://www.jstor.org/stable/3235147> accessed 3/25/08; W. Carl Biven, *Jimmy Carter's Economy: Policy in an Age of Limits* (The University of North Carolina Press, 2002) 28-9; Norman C. Thomas, "The Carter Administration Memoirs: A Review Essay" *The Western Political Quarterly*, Vol 29, No. 2, (June, 1986) 348-360, <http://www.jstor.org/stable/448303> accessed 3/27/08.

² W. Carl Biven, 62, 82-83.

³ *Ibid.*, 218, 72-82.

Carter and his economic advisors worried less about inflation than about unemployment. Ruling out anti-inflationary strategies that might negatively affect employment, such as tight fiscal and monetary policies, the administration used more subtle, long-term tactics. For example, Carter promised to study government regulations and alter the ones that needlessly drove up the price of goods. The administration also sought to restore competition and thereby lower prices through a variety of measures, including support of free international trade, enforcement of anti-trust regulations, and deregulation of several industries. Carter had promised in his 1976 campaign to pursue deregulation, and he made good on that pledge, deregulating airlines, trucking, and railroads, in addition to financial institutions by the end of his term.⁴ Carter also pledged to hold down federal spending in order to control the deficit. Finally, he asked Congress to expand the authority of the Council on Wage and Price Stability for an additional two years.⁵

The poor state of the economy and of the government bureaucracy in the late 1970s necessitated reorganization, rationalization, and consolidation of programs already in effect, not the creation of new and exciting initiatives. Furthermore, Carter's sense of fiscal responsibility dictated that programs and staffs be reduced, not expanded in an effort to cut the deficit.⁶ This work proved difficult, unpopular, and lackluster, especially

⁴ Iwan Morgan, "Jimmy Carter, Bill Clinton, and the New Democratic Economics," *The Historical Journal*, 47, 4 (2004) 1023.

<http://journals.cambridge.org.proxy1.cl.msu.edu/action/displayFulltext?type=1&fid=265030&jid=&volumeId=&issueId=04&aid=265029&bodyId=&membershipNumber=&societyETOCSession> accessed 7/10/08. Morgan explains that the idea of deregulation had become politically popular in 1975 when the Senate Subcommittee on Administrative Practice and Procedure, chaired by Edward Kennedy, held hearings on the issue.

⁵ W. Carl Biven, 127-132.

⁶ Charles O. Jones, 281; James L. Sundquist, "Jimmy Carter as Public Administrator: An Appraisal at Midterm" *Public Administration Review*, Vol. 39, No. 1 (Jan. - Feb., 1979) 3-11

for Carter, who did not find macroeconomic policy nearly as compelling as other areas such as foreign policy.⁷ However, Carter's drive to do the right thing, to pursue what was best for the American public, meant that his administration gave high priority to tackling these kinds of issues.⁸

The problems that strained the American economy at large also had negative consequences for the banking and savings and loan industries. Rising interest rates that accompanied inflation encouraged the development of higher-yielding investment instruments not subject to the rate ceilings of Regulation Q. Therefore, banks and S&Ls suffered disintermediation of funds. S&Ls in particular suffered from profit squeeze because rising interest rates meant that they paid more for deposits than they collected from their limited portfolios of long-term, fixed-rate mortgages written in the past. These problems had occurred for most of the decade, and several attempts to solve them had failed to make it through Congress.⁹ Jimmy Carter, however, entered office determined to see financial reform accomplished under his watch, and his Domestic Policy Group used all its resources to make this happen.¹⁰

As a Washington outsider and as a president determined to do what was best for the country regardless of political considerations, Carter often struggled in his relationship with Congress. He did not bring to office close relationships with

⁷ W. Carl Biven, 55; In his memoirs, Carter admitted that he found domestic policy much more difficult to enact than foreign policy. In a crisis of foreign affairs, he explained, the public gave its full support to the President. However, in matters of domestic policy, "It is almost impossible to arouse such support among a multiplicity of confusing and sometimes conflicting domestic issues," he lamented. See Jimmy Carter, *Keeping the Faith* (Bantam Books, 1982) 89.

⁸ Charles O. Jones, 297.

⁹ David Mason, 214.

¹⁰ Charles Schultze has commented on the administration's philosophical view that deregulation was desirable. See W. Carl Biven, 219. DPS memos and correspondence discussed below highlight the numerous actions taken by the department, both early and late in the process, to see to the passage of financial deregulation.

Congressional leaders, nor did he work hard to cultivate them once in office. He had no desire to bargain or compromise with Congress over programs. In fact, in Carter's view, legislative efforts were best initiated by the President and his staff, who spent much time carefully studying issues and weighing various policy options. The burden then fell on the President to offer well-researched solutions and to demonstrate public support to Congress for the proposed policy changes. Congress' job, in Carter's view, was to support the president in this process once the solutions were offered, thus he rarely collaborated with members of Congress early in the legislative process.¹¹

Carter built an apparatus to accommodate his methods for introducing and guiding legislative initiatives. His Domestic Policy Staff (DPS), headed by Stu Eizenstat, helped the president formulate policy early in the process, usually providing him with alternative courses of action, presented in detailed option papers. The DPS helped educate the president before he introduced issues to Congress. Carter then relied on his public liaison staff to build public support and to sell his ideas to Congress. Later in the process, the DPS got involved again, working with Congress directly and even lobbying on Capitol Hill. "Eizenstat noted that domestic policy advisers virtually live with Hill staff."¹²

In working with Congress, Carter again suffered, to some degree, from problems not of his making. During his term, Congress had become less responsive to the president for a number of reasons. First, the recent Watergate scandal had eroded Congress' trust in presidential authority. In addition, a significant number of retirements brought in new and ambitious members of Congress, who wanted to expand the power of

¹¹ Charles O. Jones, 272-275.

¹² Quote from Roger B. Porter, "Advising the President," *PS*, Vol. 19, No. 4 (Autumn, 1986), 867-869 <http://www.jstor.org/stable/419327> accessed 4/2/08. Charles O. Jones, 277-279.

the two houses, and were therefore less inclined to simply follow the president's lead.¹³ Carter himself noticed this trend, reflecting later that "I learned the hard way that there was no party loyalty or discipline when a complicated or controversial issue was at stake—none." This gap in party discipline allowed special interests to exert extra influence on Congress, "a highly dangerous development," in Carter's opinion. Carter also attributed Congress' lack of support to a split between conservative and liberal factions of the Democratic Party that he viewed as "impossible to heal." Also, his own narrow election victory left some question as to Carter's public mandate.¹⁴ Though Carter clashed with Congress over many of his legislative campaigns, his non-compromising manner and non-inclusive process may have actually worked well in the case of banking reform. "This unusual apparatus did contribute to the realization of the president's substantive and stylistic goals. It produced a number of victories on issues that were unpopular on Capitol Hill," explains presidential scholar Charles Jones.¹⁵

Upon entering office, the Carter administration immediately began formulating a strategy to guide financial reform legislation through Congress. In June of 1977, the administration's Economic Policy Group (EPG) sent Carter a detailed options memo, proposing a plan of action. In light of numerous failed attempts to pass far-reaching banking reform, the group recommended a more practical approach of pursuing three key legislative issues for the short term, and studying further, the more complicated and controversial measures. A memo to Carter from chairman of the Economic Policy Group, Michael Blumenthal, stated "Today, virtually no one favors another omnibus reform effort." Its prospects of passage would appear to be non-existent. The opposite

¹³ William F. Grover and Joseph G. Pescheck, 142.

¹⁴ Jimmy Carter, *Keeping the Faith* (Bantam Books, 1982) 68-9, 80. Quotes from 80.

¹⁵ Charles O. Jones, 297.

interests of the groups affected, and the difficulty of mobilizing effective support from the major beneficiaries – consumer/savers—argue for a much more selective approach.”¹⁶

The first measure recommended by the EPG was to allow all financial institutions to offer Negotiable Order of Withdrawal (NOW) accounts. In fact, they argued that NOW accounts should be the only reform vigorously pursued in 1977. Created in 1972 to compete with the phenomenally popular money market accounts that were attracting away deposit dollars, NOW accounts paid interest on savings, yet allowed depositors to write a limited number of checks to access their funds.¹⁷ Institutions generally charged a fee for each check. In 1973, Congress formally allowed them in Massachusetts and New Hampshire as an FDIC-regulated experiment. By 1976, Congress permitted financial institutions in the other New England states--Maine, Vermont, Rhode Island, and Connecticut--to offer them as well. In 1975, the House of Representatives considered legislation that would permit NOW accounts throughout the nation, but the bill failed. The issue surfaced again in 1977 in the House Subcommittee on Financial Institutions, which debated allowing NOW accounts in New Jersey, New York, and Pennsylvania, again without success.¹⁸ Carter’s Economic Policy Group proposed legislation that would authorize all depository institutions to offer NOW accounts to household

¹⁶“Memo from Rick Hutcheson to Michael Blumenthal, June 8, 1977, Financial Institutions Reform” Financial Institution Reform 6/8/77, Box 102, Staff Office Files: Office of Congressional Liaison Lisa Bordeaux, Jimmy Carter Presidential Library. Note that this memo transmitted Carter’s response to the memo Michael Blumenthal sent him one day earlier regarding financial institutions reform. A copy of Blumenthal’s memo is attached, with Carter’s handwritten notes.

¹⁷ David Mason, 194; House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing, *Consumer Checking Account Equity Act of 1979*, 96th Congress, 1st session, May 15, 1979, 77-80.

¹⁸House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing, *Consumer Financial Services Act of 1977 (NOW Account Legislation)*, 95th Congress, 2nd session, September 7, 1977, 40; House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing, *Consumer Checking Account Equity Act of 1979*, 96th Congress, 1st session, May 15, 1979, 80-84. Lewis J. Spellman, *The Depository Firm and Industry: Theory, History, and Regulation* (Academic Press, 1982) 38.

customers, at a rate set by regulators, with equal reserve requirements for all institutions. The group justified this recommendation by explaining that the prohibition against paying interest on demand deposits “has eroded through innovation and eventually will erode completely.”¹⁹

In fact, the EPG argument was convincing. Technological innovations during the 1970s, particularly electronic funds transfer, influenced daily transactions in banking and affected the industry’s future regulatory structure. Over the course of the decade, technological progress made it possible to conduct more and more business functions electronically. For example, in 1972, the Federal Reserve Bank of San Francisco experimented with carrying out internal transactions with its Los Angeles branch electronically. By 1978 all Federal Reserve Banks had begun to use this system. In 1975 the Social Security Administration and other government retirement systems gave collectors the option to use direct deposit. Electronic deposit of payroll spread quickly, both in the public and private realms, as did automatic payroll deductions for retirement accounts, insurance, and mortgages. In terms of account access, the first automated teller machines (ATM) came into use in 1971, allowing customers to conduct their banking activities any time of day, sometimes without going to the bank.²⁰ Furthermore, in 1974, First Federal Savings and Loan in Lincoln, Nebraska installed the first point-of-service payment terminals in the local supermarket. Customers need not withdraw cash from an ATM machine or write checks for their purchases. The terminal automatically deducted

¹⁹ Memo from Rick Hutcheson to Michael Blumenthal, June 8, 1977, “Financial Institutions Reform” Financial Institution Reform 6/8/77, Box 102, Staff Office Files: Office of Congressional Liaison Lisa Bordeaux, Jimmy Carter Presidential Library.

²⁰ The first ATM machines were located at bank branches. See David Mason 192.

the exact amount of the purchase from the customer's First Federal account.²¹ This technology spread rapidly during the remainder of the decade. Also in the early 1970s, the Federal Reserve, which acted as a check clearing house for its members, began to develop the Automated Clearing House (ACH), to process payments without the use of paper checks. Originally ACH used magnetic tapes to record the information and delivered the tapes to member institutions, but eventually all information came to be transmitted electronically.²²

Savings and loans utilized electronic funds transfer beginning in the early 1970s, using the Transmatic System (TMS), created by First Federal Lincoln of Omaha. The system allowed customers to authorize direct deposits and mortgage payments. By 1974, TMS remote service units placed in supermarkets allowed customers to authorize checks, make deposits and withdrawals, pay bills, and use debit cards with participating merchants.²³

Technological developments had significant competitive consequences in the financial industry. Brokers and individuals gained the ability to follow interest rates on their investments closely, which presented new competition for S&Ls, who were again limited by Regulation Q in the amount of interest they could pay on deposits. With easy and continual access to information, consumers became increasingly savvy. Furthermore, they could quickly and easily move deposits from one institution to another, from one deposit instrument to another, and even to investments outside of the banking sector, particularly money market mutual funds, in search of higher rates of return. This

²¹ Jack Weatherford, *The History of Money* (Crown, 1997) 233-236; Frederick E. Balderston, 7.

²² "Automated Clearing Houses (ACHs)" Federal Reserve Bank of New York, <http://www.ny.frb.org/aboutthefed/fedpoint/fed31.html>, accessed 6-17-2008.

²³ David Mason, 192-193.

was especially encouraged by the high rate of inflation during the late 1970s, which threatened to erode the value of low-yielding investments considerably.

New electronic banking technology also created the difficult regulatory issues alluded to by Carter's Economic Policy Group. For example, some argued that automated teller machines, which could perform all or most of the functions of a banking branch, constituted a violation of branching limitations.²⁴ Furthermore, the ability to access savings through point-of-sale transactions meant that passbook savings accounts functioned more like checking accounts, which by regulation could only be offered by commercial banks. Likewise, the ability to electronically transfer funds quickly and easily from savings to checking accounts meant that customers were, in essence, earning interest on their demand deposits, also a violation of banking legislation. The new access and payments systems also broke down the barriers separating what had been discrete segments of banking. Credit unions, savings and loans, and commercial banks could all now *in effect* offer *checking-like* accounts that paid interest. Each segment of the financial industry tended to object to regulations that allowed its competitors to utilize new services. For example, when the Fed proposed that banks be permitted to offer automatic transfer from savings to checking accounts, the chairman of the FHLBB vehemently opposed the idea, complaining that it would put savings and loans at a competitive disadvantage in procuring funds and might deliver "a crippling, debilitating blow to the supply of mortgage credit."²⁵ Legislation confirming the legality of interest

²⁴ In 1985, the U.S. Supreme Court ruled that ATMs were not the same as branches and thus interstate ATM networks did not violate branching regulations. Fumiko Hayashi, Richard Sullivan, and Stuart E. Weiner, "A Guide to the ATM and Debit Card Industry," Federal Reserve Bank of Kansas City, <http://www.ffiec.gov/ffiecinfobase/resources/retail/frb-guide%20to%20the%20atm%20debit%20card%20ind.pdf> accessed 6-19-08.

²⁵ Judith Miller, "Banks' Automatic Shift of Savings To Checking Accounts Held Illegal," *The New York Times*, April 20, 1977, ProQuest Historical Newspapers The New York Times (1851 - 2005); Judith Miller,

on demand deposits for all banking segments would make for a “more orderly transition,” argued the Economic Policy Group. Carter penned “ok” next to this proposal on the options memo, apparently indicating his approval.²⁶

The EPG’s second proposal, to allow the Federal Reserve to pay interest on reserves, addressed concerns about membership attrition in the Federal Reserve System. The Fed required member banks to put aside reserves based on deposit liabilities. It held those reserves without paying interest, and conducted monetary policy by adjusting required reserve levels. On the other hand, nonmembers held smaller reserves, and could earn interest by investing them, which lowered their costs of doing business. “For this reason, medium-sized and smaller banks recently have been withdrawing from membership at a growing rate. As a result, Fed earnings may be weakened,” the memo stated. Federal Reserve Chairman Arthur Burns worried that a further drop in membership might compromise the Fed’s ability to carry out monetary policy. The issue became tied to NOW accounts because paying interest on demand accounts would lower bank earnings, and perhaps entice banks to recoup the difference by withdrawing from the Federal Reserve System. The Economic Policy Group thus recommended that “this legislation include authorization for the Federal Reserve to pay interest on its member bank reserves, not to exceed \$150-\$250 million of budget cost.” Again, the president wrote “ok” next to the proposal.²⁷

“Fed Moving to Let Banks Pay Interest On Check Accounts,” *The New York Times*, February 3, 1978, ProQuest Historical Newspapers The New York Times (1851 - 2005).

²⁶ Memo from Rick Hutcheson to Michael Blumenthal, June 8, 1977, “Financial Institutions Reform” Financial Institution Reform 6/8/77, Box 102, Staff Office Files: Office of Congressional Liaison Lisa Bordeaux, Jimmy Carter Presidential Library.

²⁷ Ibid.; The \$150-\$250 cap on budget cost came from Fed negotiations with the Treasury. The Fed originally proposed a program of higher interest payments on reserves, but the Treasury would not recommend to the Office of Management and Budget a plan that cost more than \$150-\$250 million – the amount that the EPG estimated would be lost in revenue if membership decline continued at the current rate.

The last measure of immediate importance involved a two-year extension of interest rate ceilings on deposits through Regulation Q. The EPG proposed the extension despite the group's stance that ceilings failed to do what they were intended to do -- keep funds flowing into the mortgage market. "Regulation Q ceilings are counterproductive -- they actually weaken savings flows and mortgage lending." However, EPG members realized that savings and loans and the housing industry perceived Regulation Q ceilings as helpful to their deposit flows and would not give them up easily. Thus, they determined, "It is unrealistic, therefore, to seek their elimination without a sound housing finance alternative. A two-year extension should provide adequate time to prepare one." The group further explained that the extension would be opposed by both thrift institutions, who wanted a longer extension, and commercial banks, who wanted to do away with the housing differential -- the ¼% extra that savings and loans were permitted to pay on deposits over commercial banks to encourage funds to flow into housing. Next to this proposal, Carter penned, "I have no interest in Reg Q -- but do not oppose this extension." In an earlier section of the memo dealing with Regulation Q, Carter wrote "Study phasing out."²⁸

In reality, interest rate ceilings were already being phased out. Regulators had by now allowed depository institutions to offer investment instruments that paid rates of return above the Regulation Q limits, such as high denomination certificates of deposit and small saver certificates. Pressure to allow these savings options came from competing alternatives such as money market mutual funds in the late 1970s. Depository institutions suffered from disintermediation as consumers moved their money to higher paying alternatives. The new savings options helped institutions keep their deposits.

²⁸ Ibid.

Al

For

Eu

ce

ga

sa

pa

inc

rec

co

ga

ad

ce

m

C

th

R

D

R

fo

—
s

x

h

M

Also, these instruments helped to level the playing field among depository institutions. For example, large banks, with operations abroad, had the opportunity to turn to the Eurodollar market for funds when market rates of interest climbed above Regulation Q ceilings because dollar deposits abroad were not subject to Regulation Q limits. This gave them an unfair advantage over smaller banks, S&Ls, credit unions, and mutual savings banks. This put pressure on regulators to give other institutions a means for paying higher rates, further weakening rate ceilings. By the late 1970s, about ¾ of the industry's savings paid interest rates above the ceiling rate.²⁹

Finally, the EPG finished by highlighting areas for further study, including redlining, electronic funds transfer, regulations on U.S. bank lending to less developed countries, and expansion of lending powers for federal savings and loans. Carter again gave this section of the memo his "ok."³⁰ Shortly after the memo circulated, the administration formed an Interagency Task Force on Regulation Q to study interest rate ceilings and other issues. The Treasury Department chaired the task force, whose members included the Department of Housing and Urban Development (HUD), the Council of Economic Advisors (CEA), the Office of Management and Budget (OMB), the Domestic Policy Staff (DPS), and the President's Adviser on Consumer Affairs. Regulatory agencies, including the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Home Loan Bank Board, the Federal Reserve Board, and the National Credit Union Administration, also worked with the task force.³¹ Thus, by the summer of 1977, the administration had settled on a strategy of

²⁹ Richard N. Cooper and Jane Little, "Competition and Opportunity;" David Mason, 190-191.

³⁰ Ibid.

³¹ Memorandum from Ernest H. Preeg to Secretary Blumenthal, June 14, 1977, "Follow-on Work to EPG Memo on Financial Institutions and Bank Regulatory Reform" Banking Reform – Banking, Box 150, Staff

heavily pursuing NOW accounts while studying more far-reaching reforms and looking for ways to build consensus. The approach was Carter-like in that it provided for deep study as well as input and support from an Inter-Agency Task Group. It perhaps deviated from Carter's preferred methods of doing business in that it sought a partial solution at first, with a more complete solution to be achieved later. Carter tended to like whole solutions and was not generally this patient. However, even if Carter did not pay attention to politics, many on his staff did. For example, Michael Blumenthal was well attuned to the fact that Congress had repeatedly turned down efforts at financial reform and that a complete solution had very low prospects for passage.³²

In fact, even the pragmatic approach of taking on a few issues at a time did not prove successful. By October of 1978, Congress had passed the next piece of financial reform legislation, the Financial Institutions Interest Rate Control Act of 1978. The law addressed a smorgasbord of issues from insider lending, to interlocking management and director relations, to consumer protection, to the creation of a Federal Financial Institutions Examination Council to standardize examination of financial institutions. It also raised the limit of deposit insurance on IRA and KEOGH retirement accounts from \$40,000 to \$100,000. In terms of savings and loans, the act authorized S&Ls to make loans for land development, construction, and education with up to 5% of assets. As Carter's EPG recommended, the act extended the Fed's authority to set interest rate

Office files: Domestic Policy Staff, Eizenstat, Jimmy Carter Presidential Library; Memorandum to Vice President Mondale, Alfred E. Kahn, Esther Peterson, Charles L. Schultze, Anne Wexler, and Frank Moore from James T. McIntyre, Jr., May 4, 1979, "Recommendations of the Regulation Q Task Force" Regulation Q, Box 74, Staff Office Files: Council of Economic Advisors,, Charles L. Schultze, Jimmy Carter Presidential Library. Note that this memo simply transmitted a copy of the memo prepared by the Treasury Department regarding "Issues Developed by the Regulation Q Task Force." McIntyre was collecting comments on the recommendations before sending them to President Carter.

³² See Memo from Rick Hutcheson to Michael Blumenthal, June 8, 1977, "Financial Institutions Reform" Financial Institution Reform 6/8/77, Box 102, Staff Office Files: Office of Congressional Liaison Lisa Bordeaux, Jimmy Carter Presidential Library.

ceilings on deposits for about two more years until the administration could develop an alternative program for S&Ls. However, the law did not contain the one provision most sought after by the Carter administration – nationwide authority to write NOW accounts. It fell considerably short, adding only New York to the list of states permitted to offer them.³³ Thus, even the focused efforts of the Carter administration to conquer one issue at a time proved difficult in 1978. The political environment that kept financial reform from passing in the mid 1970s had not changed much. The various sectors of the banking industry still opposed deregulation for fear that the changes it wrought would create a competitive disadvantage. Despite the disappointment, Carter signed the bill on November 10, 1978, optimistically commenting that “The cooperative spirit which led to this legislation testifies to the basic soundness and health of our Nation’s depository institutions.”³⁴

Though NOW accounts did not become widely available, the issue of checking-like accounts that in effect, paid interest remained controversial and chaotic as Carter’s EPG had predicted. The chaos came to a head in an April 22, 1979 appellate circuit court case in the District of Columbia. The decision combined three separate cases in which competing segments of the financial industry sued each other in an attempt to keep others from offering interest on checking. The American Bankers Association sued the National Credit Union Administration over the regulation allowing share draft accounts; the Independent Bankers Association of America sued the Federal Home Loan Bank Board over the regulation allowing remote service units; and the

³³ The Library of Congress, Thomas, “H.R... 14279” <http://thomas.loc.gov/cgi-bin/bdquery/z?d095:HR14279:@@L&summ2=m&>> Accessed March, 21, 2008; David Mason, 209.

³⁴Statement by the President, November 10, 1978, Banking Reform—Banking, Box 150, Staff Office Files: Domestic Policy Staff – Eizenstat, Jimmy Carter Presidential Library.

United States League of Savings Associations sued the Federal Reserve Board and the Federal Deposit Insurance Corporation over regulations permitting the use of automatic transfer accounts by commercial banks.³⁵ Only the credit unions refrained from trying to stop competitors from offering interest on demand deposits.³⁶ The court overruled a district court decision which supported institutions' rights to offer these services. On the contrary, the court ruled that the use of this "device or technique was not authorized by the relevant statutes, although permitted by regulations of the respective institutions' regulatory agencies." These services violated New Deal legislation that prohibited the payment of interest on demand deposits and separated the functions of banking into segments, with commercial banks being the only segment allowed to offer demand deposits. The court observed that the effect of the new practices was "that three separate and distinct types of financial institutions created by Congressional enactment to serve different public needs had now become, or are rapidly becoming three separate but homogenous types of financial institutions offering virtually identical services to the public." The court ruled to set aside the regulations authorizing the new practices, but stayed the decision until January 1, 1980 "in the expectation that the Congress will declare its will upon these matters."³⁷ The court was responding to the delicate condition at hand. Financial institutions had invested considerable capital in creating the new services, and consumers had become accustomed to using them.³⁸ Instead of

³⁵ *Update on Consumer Checking Account Equity Act of 1979*, H.R. 3864, 96th Congress, 1st session, *Congressional Record* 125 (July 16, 1979): 18836-18837.

³⁶ *The Successful Experiment is Extended*, H.R. 3864, 96th Congress, 1st session, *Congressional Record* 125 (July 27, 1979): 21048-21049.

³⁷ *United States League of Savings Association v. Board of Governors of the Federal Reserve System, et al.* 463 F. Supp. 342 1978 (DC: Dist 1978)

<http://www.lexisnexis.com.proxy1.cl.msu.edu:2047/us/Inacademic/deli...>, accessed 6-19-08

³⁸ According to House Subcommittee on Financial Institutions Chairman St. Germain, 1 1/2 million credit unions offered share draft accounts, and 3000 remote service units existed that accommodated account

immediately prohibiting these practices, which would, the court acknowledged “have a deleterious impact on the financial community as a whole,” the court gave Congress time to act.³⁹ The decision placed a tremendous obligation on Congress to pass deregulatory legislation that addressed this trend of homogenization among what had been separate branches of banking. This pressure to deal with changes in the financial sector surely aided in the passage of DIDMCA.

In the meantime, economic conditions were worsening. The major problem involved inflation. While the Carter administration did not view inflation as the most urgent problem in 1977, it remained stubbornly high, with the Consumer Price Index measuring 7.7% in 1978, and climbing steeply to 13% during the first 4 months of 1979. This was partly attributable to rising food costs and to OPEC’s price increase of that year. By 1979, the administration, which originally tried to convince the Fed not to tighten the money supply, changed strategies and asked for more constrictive monetary policy. William Miller, the Chairman of the Fed, hesitated however, fearful of causing a recession.⁴⁰

The administration took other steps in light of its increasing concern over the inflation rate. In April of 1978, Carter announced that he would cap federal wage increases at 5 ½% rather than at the typical level of 7%. He urged the private sector to follow his lead. Carter also introduced voluntary wage price standards in October of 1978, and appointed Alfred Kahn, former head of the Civil Aeronautics Board, as head of

balances of over \$2.65 billion. See *Update on Consumer Checking Account Equity Act of 1979*, H.R. 3864, 96th Congress, 1st session, *Congressional Record* 125 (July 16, 1979): 18836-18837.

³⁹ *United States League of Savings Association v. Board of Governors of the Federal Reserve System, et al.* 463 F. Supp. 342 1978 (DC: Dist 1978)

<http://www.lexisnexis.com.proxy1.cl.msu.edu:2047/us/Inacademic/deli...>, accessed 6-19-08.

⁴⁰ W. Carl Bevin, 144, 186-190.

the Council on Wage and Price Stability and his personal inflation advisor. In September of 1979, Carter accepted a recommendation from the Tripartite Pay Advisory Committee, made up of representatives from labor, business, and the general public, to keep wage increases between 7.5% and 9.5%, though his advisors felt the level to be far too high.⁴¹ These measures, however, proved ineffective in slowing the alarming growth of inflation, especially given oil price increases in 1979. The private sector simply disregarded voluntary guidelines, indicating that stronger and more painful action would have to be taken.⁴²

The pain would be inflicted, not by Carter, but by the new Chairman of the Federal Reserve, Paul Volcker.⁴³ Carter appointed Volcker against the wishes of his economic advisors because he felt so strongly about the need to address inflation. Volcker was willing to make the difficult decisions that he believed were a necessity. Kahn recalls discussing the administration's voluntary wage and price controls with Volcker, "And I remember Paul Volcker saying to me, he said, 'Fred, that program is simply not working. I'm the only one in town who has the weapon that can be used, and sooner or later I'm going to have to use it.'"⁴⁴ Volcker's weapon would be control of the money supply regardless of the resulting effects on interest rates and economic growth. This strategy, though painful in the short run, made sense to Volcker, "We'll take the emphasis off of interest rates and put the emphasis on the growth in the money supply,

⁴¹ Ibid., 134-137, 186, 193-196

⁴² Iwan Morgan, 1024.

⁴³ The position of Chairman of the Fed became available because Michael Blumenthal, Secretary of the Treasury resigned as part of the shake-up of staff following Carter's 10-day Camp David retreat and his "Malaise" speech. Carter asked the current head of the Fed, William Miller to take over as Secretary of the Treasury and appointed Volcker despite the candidate's warning that he would be "fiercely independent." See W. Carl Bevin, chapter 2.

⁴⁴ Ben Wattenburg, "The Changing Economy: Inflation, Stagflation, and Deregulation" Interview with Alfred Kahn and Paul Volcker, *The First Measured Century*, <http://www.pbs.org/fmc/segments/progseg14.htm>, accessed July 1, 2008.

which is at the root cause of inflation; too much money chasing too few goods in the old proverbial way of putting the inflationary process.”⁴⁵ Volcker’s policies drove interest rates to unprecedented heights and created a recession by the second quarter of 1980.⁴⁶ The federal funds rate climbed above 13% in 1979 and the prime rate topped out at 15.3% that year.⁴⁷

Rates of this magnitude began to cause serious problems for S&Ls, and projections about the future of thrift institutions and the housing market became grim. For example, FHLBB Chairman Jay Janis complained to Carter’s Chairman of the Council of Economic Advisors that inflation was causing a loss of earnings for S&Ls. “Many institutions are believed to be operating in the red right now,” warned Janis. He went on to estimate that “by the end of 1980, depending on the interest rate scenario, between 50 and 75 percent of all savings and loan associations will be operating in the red. For the industry as a whole for 1980, we project that earnings will be in the range of -0.25 to -0.60 percent.” Under these earnings estimates, many institutions would have net worth problems as well, explained Janis. The underlying problem, according to the Bank Board chairman, lay in the high rates that S&Ls had to pay to attract deposit funds – a direct result of high inflation. Thus, his suggested solution involved controlling

⁴⁵ Ibid.

⁴⁶ W. Carl Bevin, 242-250.

⁴⁷ Federal Reserve, “Federal Funds Rate”

http://www.federalreserve.gov/releases/h15/data/Monthly/H15_FF_O.txt accessed April 7, 2008; Federal Reserve, “Prime Rate” http://www.federalreserve.gov/releases/h15/data/Monthly/H15_PRIME_NA.txt accessed April 7, 2008.

inflation.⁴⁸ Carter Administration economist, Burke Dillon, found Janis' estimates to be "reasonable although perhaps somewhat pessimistic."⁴⁹

The Treasury too saw severe problems afflicting the industry, projecting negative earnings for 1980 and the possibility of closure for "a few particularly poorly managed mutuals and S&Ls..." The Treasury stressed the need for flexible and effective management of the problem by regulators, warning that "if the regulators cannot deal with the pathologic cases adequately, a crisis of confidence and financial disruption could develop."⁵⁰

A month before DIDMCA was passed, Tony Frank, the President of a large California S&L wrote Carter's Senior Domestic Advisor, alerting him that impending disaster for the industry was close at hand and that the repercussions could very well "destroy President Carter's chances for re-election." He cautioned that a large banking run could cause several thrifts and banks to close in the next couple of months, and as "a staunch supporter, both with thought and money," he complained, "that considerably more urgency is attached to the matter of the financial system in this Country than is publicly exhibited by the White House at the present time."⁵¹

The Savings and Loan industry also held pessimistic views about the effects of Volker's policies on profitability and on the availability of housing funds. Executive

⁴⁸ Memorandum from Jay Janis to Charles L. Schultz, March 5, 1980, "Projected 1980 Earnings of Savings and Loan Associations," 12/07/1976-01/06/1981, Box 73, Federal Home Loan Bank Board, Jimmy Carter Presidential Library.

⁴⁹ Memorandum from Burke Dillon to Charlie Schultz, March 10, 1980, "Estimates of S&L Earnings for 1980," Council of Economic Advisors, Box 74, White House Central Files: Charles L. Schultze's, Jimmy Carter Presidential Library.

⁵⁰ Memorandum from Robert Carswell to Economic Policy Group, "Thrift Industry Losses in 1980" March 26, 1980, EPG Steering Group 3/28/80, Box 113, Staff Office Files: Council of Economic Advisors, Jimmy Carter Presidential Library.

⁵¹ Letter from Tony Frank to Stuart Eizenstat, February 28, 1980, Depository Institutions Deregulation Act of 1979, Box 106, Staff Office Files: Domestic Policy Staff, Eizenstat, Jimmy Carter Presidential Library.

Vice President of the U.S. League of Savings Associations, Norman Strunk, issued a letter to member institutions, predicting sizeable disintermediation, steeply rising costs of procuring funds, and perhaps even a drying up of available mortgage finance in some states. U.S. League economists expected that the rising interest rates would drive more savers to money market funds and away from passbook savings. "In many cases associations will find the cost of money to replace that lost through disintermediation to be such as to make uneconomic anything like the continuation of normal lending," warned Strunk. Lending would suffer because the dwindling passbook savings that provided the industry with capital would have to be replaced by funds raised through jumbo certificates and Federal Home Loan Bank advances. However, the interest rates for these were prohibitively high, indeed higher than state usury ceilings for mortgages in 22 states. Some institutions had already suspended lending by November of 1979. The hard times, however, did not sway the League's belief that the industry needed Regulation Q deposit rate ceilings. League economists complained that "rising interest rates may intensify pressures to raise Regulation Q ceilings. Costs of such a change would break the back of some institutions."⁵² Clearly, much of the industry still felt it would be better to lose a hefty portion of their liabilities to higher yielding investments than it would be to pay market rates of interest. Savings and loan deposits, profits, and capital all declined in 1979 and by 1980, it looked as though a true crisis might be close at hand.⁵³

⁵² "Anti-Inflation Move Spurs Credit Crunch For Home Lenders," *Savings & Loan News* 100, part 2, (November 1979): 6-7.

⁵³ Memorandum from Robert Carswell to Economic Policy Group, "Thrift Industry Losses in 1980" March 26, 1980, EPG Steering Group 3/28/80, Box 113, Staff Office Files: Council of Economic Advisors, Jimmy Carter Presidential Library.

A Brookings Institution study of savings and loans also provided a bleak outlook for the future. Their forecasting model predicted that perhaps as many as one out of every four thrifts would cease to exist in the future. Most of these disappearances would occur through mergers, the study predicted, but “up to 625 firms with combined assets of \$83.4B” would require help from FSLIC to cover their merger or liquidation. This would eventually strain the resources of FSLIC, the study explained, and force the agency to seek more funds from the U.S. Treasury or the Federal Reserve.⁵⁴

The signals of imminent calamity--extremely high inflation, soaring interest rates, the movement of consumer deposits out of institutions subject to Regulation Q, the prospect of loss of public confidence and bank runs--all pressured the various sectors of the financial industry to compromise. Furthermore, the “philosophy of deregulation had swept the country,” explains Robert Dugger, who served as Chief Economist of the Senate Banking Committee and Senior Staff Member of the Financial Institutions Subcommittee of the House Banking Committee in the 1980s. The combination of these forces, he agrees, helped to end a decade of squabbling among the various groups affected by banking deregulation and persuaded them to support the legislation.⁵⁵

By 1979 Carter had become less patient in his mission for financial reform. A memo about the “Regulation Q Timetable” discussed “the President’s directive that we move ‘aggressively’ on structural banking deregulation.”⁵⁶ The administration also became more creative. Given the difficulties encountered in trying to move financial reform legislation through Congress, they contemplated circumventing the legislative

⁵⁴ Andrew S. Carron, 27-32.

⁵⁵ Robert F. Dugger, phone interview by Jill S. Huerta, November 21, 2008.

⁵⁶ Memo from Orin Kramer to Stu Eizenstat, February 28, 1979, “Regulation Q Timetable,” Regulation Q, Box 74, Staff Office Files: Council of Economic Advisers, Charles L. Schultze’s, Jimmy Carter Presidential Library.

process by executing some reforms through administrative action by regulatory agencies. For example, a memo explaining the Task Force's preliminary recommendations, pondered, "Many of the changes suggested could be implemented by administrative action of the Federal Reserve Board, the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation."⁵⁷ Another memo concluded that perhaps the administration could persuade regulatory agencies to phase out Regulation Q ceilings.

With respect to changes on Regulation Q ceilings, however, voluntary administrative action by the regulatory agencies would be preferable to a tough legislative fight. Administrative changes on Regulation Q ceilings require the concurrence of the Federal Reserve, the FDIC and the Bank Board ...None are likely to want to be perceived as taking the lead for change in this area; if significant action is possible, they must be led by the Administration."⁵⁸

However, by the time the Regulation Q Task Force made its final recommendations, the administration seemed resigned to the need for Congressional support, explaining that

Each of the options below could be accomplished through legislation or through administrative action on the part of the bank regulators. Because of the high degree of emotion involved, the ability of regulators to act is restricted. As a practical matter, we believe that only option 2b (more flexible ceilings) could be effectuated by the regulators without legislative action, and even that should have an element of overall legislative direction."⁵⁹

In addition to the complex vying for advantage among financial industry interest groups, the politics within the Interagency Task Force also proved to be divisive, with banking regulators pulled in various directions by the interests of the sectors they

⁵⁷ Memo from Robert Carswell to Members of the Regulation Q Task Force, February 9, 1979, Regulation Q, Box 74, Staff Office Files: Council of Economic Advisers, Charles L. Schultze, Jimmy Carter Presidential Library.

⁵⁸ Memo from Orin Kramer to Stu Eizenstat, February 28, 1979, "Regulation Q Timetable," Regulation Q, Box 74, Staff Office Files: Council of Economic Advisers, Charles L. Schultze's, Jimmy Carter Presidential Library.

⁵⁹ Memorandum to Vice President Mondale, Alfred E. Kahn, Esther Peterson, Charles L. Schultze, Anne Wexler, Frank Moore from James T. McIntyre, Jr., May 4, 1979, Regulation Q, Box 74, Staff Office Files: Council of Economic Advisors: Charles L. Schultze, Jimmy Carter Presidential Library.

regulated. An internal White House memo discussed the pressures affecting each regulator. For example, the FDIC, which supervised mutual savings banks, expressed concern that higher interest rates would put undue strain on these institutions, which had already been hurt by high interest rates. Also, smaller banks, regulated by the FDIC, strongly supported rate ceilings, though they opposed the housing differential accorded to thrifts. Likewise, savings and loans had struggled in the high interest rate environment, making it “politically difficult for McKinney to advocate raising deposit rate ceilings (i.e. the S & L’s cost of funds) during such a period...” Even the Federal Reserve, which had strongly supported the elimination of deposit rate ceilings all along, hesitated to take the lead in this action because of the problems experienced by the thrift industry.⁶⁰ There was also a significant lack of harmony between the rest of the Task Force and HUD, which opposed most of the program recommended, fearing that it would have negative consequences on the supply of mortgage funds.⁶¹ In fact, Orin Kramer suggested that Eizenstat hold a meeting with HUD to give the agency “an opportunity to express its strong opposition to the thrust of Treasury’s Reg Q recommendations, to evidence your strong commitment to working closely with HUD on this issue...”⁶² Like savings and loans, HUD felt that Regulation Q and the housing differential that gave thrifts an edge over commercial banks in attracting deposits, protected housing funds. However, Kramer advised Eizenstat to remind HUD that Regulation Q “cannot protect thrifts against deposit outflows to other unregulated money market instruments. It is arguable that as

⁶⁰ Memorandum from Orin Kramer to Stu Eizenstat, February 28, 1979, “Recommendation of the Regulation Q Task Force,” Regulation Q – Banking, Box 268, Staff Office Files: Domestic Policy Staff – Eizenstat, Jimmy Carter Presidential Library.

⁶¹ According to Orin Kramer, HUD’s constituency included both S&Ls and builders. Orin Kramer phone interview by Jill S. Huerta, September 17, 2008.

⁶² Memo from Orin Kramer to Stu Eizenstat “meeting on Regulation Q,” March 2, 1979, Regulation Q—Banking, Box 268, Staff Office Files: Domestic Policy Staff, Eizenstat, Jimmy Carter Presidential Library.

savers become more sophisticated, and as such instruments proliferate, thrifts will be required to offer higher deposit rates in order to remain viable and maintain their role as our major source of mortgage credit.”⁶³ According to Kramer, the internal disputes with HUD were eventually resolved when Bob McKinney stepped down as the head of the FHLBB. Jay Janis, the Undersecretary of HUD expressed an interest in the job. When Kramer asked him how he could want that job when he disagreed with all the administration’s policies towards thrifts, he replied, “I just became an advocate,” thereby ending opposition from HUD.⁶⁴ The difficult political environment inside the Carter Task Force reflected the difficult political environment outside, with the depository institutions affected by deregulation, bargaining and negotiating for advantage.

Carter’s Task Force made its final analysis and recommendations about Regulation Q interest rate ceilings and thrift asset powers in the Spring of 1979. Reviewing the regulatory system created by the New Deal, the Task Force commented that, “so long as institutions borrow short-term funds and lend long-term funds, that result is a constant risk.”⁶⁵ Interest rate controls on deposits were implemented for thrifts, the group explained, in the high interest rate environment of the mid 1960s, to prevent S&Ls from paying excessively high returns on short term funds, which they could not afford because of the long-term, lower yielding nature of their mortgage-dominated investment portfolios. Further, the rate controls sought to channel capital into S&Ls and thus into housing by setting the ceiling for deposit rates higher for thrifts than for commercial

⁶³ Ibid.

⁶⁴ Orin Kramer, phone interview by Jill S. Huerta, September 17, 2008.

⁶⁵Memorandum to Vice President Mondale, Alfred E. Kahn, Esther Peterson, Charles L. Schultze, Anne Wexler, Frank Moore from James T. McIntyre, Jr., May 4, 1979, “Recommendations of Regulation Q Task Force,” Regulation Q, Box 74, Staff Office Files: Council of Economic Advisors: Charles L. Schultze, Jimmy Carter Presidential Library.

banks. The idea behind this was that S&Ls were less able to attract consumer deposits because by law they could not offer convenient consumer services such as checking accounts, credit cards, and consumer loans. However, the task force argued that rate controls had not protected financial institutions as well as planned. Instead, “the distorting effects of the ceilings have created pressure for exceptions.” In commercial banking, ceilings had limited the ability of banks to compete for funds, the analysis explained, causing them to turn to Eurodollars to procure capital. Also during times of high interest rates, ceilings had led to disintermediation. Increasingly knowledgeable consumers moved their money to higher yielding investments, causing thrifts to respond with new deposit instruments such as the money market certificate, with its interest rate pegged to the six-month Treasury bill. This had squeezed the earnings of S&Ls, but protected the flow of funds into housing.⁶⁶ In fact, by 1980, the new deposit instruments paying market rates of interest, such as jumbo money market certificates, already accounted for about a third of savings and loan deposits, making liabilities much more sensitive to market forces than assets, explained a Brookings Institution study on economic regulation. By the end of 1980, 79.8% of S&L assets were invested in mortgage loans.⁶⁷ This told an interesting story, pointed out the task force, one that seriously questioned the validity of using rate ceilings to channel money into housing. Regulation Q had not protected housing funds. The exceptions to Regulation Q had been responsible for keeping funds flowing into S&Ls and thus into housing. Housing capital had been protected, but the tradeoff was falling profitability.⁶⁸

⁶⁶ Ibid.

⁶⁷ Andrew S. Carron, 9-13.

⁶⁸ Ibid., 5.

Another problem with interest rate ceilings lay in their effect on small savers, argued the task force. Savers with ample funds had several alternatives for earning higher rates of interest such as \$100,000 certificates of deposit, four year certificates of deposit, and \$10,000 money market funds. However, depositors with less than \$10,000 in savings or those who might need immediate access to their funds had no alternative but to use standard savings accounts, which paid significantly less. While the task force did not offer one definitive solution to the problem of interest rate ceilings, all members except HUD favored some form of action towards weakening or abolishing them. The task force also preferred to link the phase-out of interest rate ceilings to the expansion of asset powers for savings and loans to allow investment in some higher yielding assets. Higher earnings on the asset side would better enable thrifts to pay market rate for deposits without causing a drop in earnings. Likewise, the task force recommended that S&Ls be allowed to offer interest-bearing checking accounts. While the task force presented these steps as a “Coordinated Program,” it did not insist that asset powers had to accompany deregulation of rate ceilings.⁶⁹

Finally the task force was split in opinion with regard to variable rate mortgages. The Treasury, the Council of Economic Advisors, the Federal Home Loan Bank Board, the Office of the Comptroller of the Currency, and the National Credit Union Administration all supported authorizing variable rate mortgages nationally, while HUD and the FDIC opposed the idea.⁷⁰

On May 22, 1979, Carter sent a message to Congress proposing financial reform legislation that reflected the recommendations of his Task Force, as well as many of the

⁶⁹ Ibid., 6-10.

⁷⁰ Ibid., 22.

suggestions of the Friend, Hunt, and FINE studies. Carter asked Congress to allow interest rates on deposits to rise to market rates “through an orderly transition period,” and with the right of regulators to take “emergency action” to protect the soundness of financial institutions or to conduct monetary policy if necessary. On the liability side, Carter also asked that all federally insured financial institutions be allowed to offer interest-bearing transaction accounts for individuals. On the asset side, Carter asked Congress to allow federal savings institutions to phase in variable rate mortgages to their portfolios and to invest up to 10% of their assets in consumer loans.⁷¹ The next day, *The New York Times* reported somewhat pessimistically, “The endorsement is expected to touch off a legislative free-for-all on Capitol Hill. It will almost surely meet fierce opposition from savings and loan associations, which have blocked previous efforts to lift interest rate ceilings.”⁷²

The *Times* had good reason to be pessimistic, since past efforts at passing very similar legislation had failed miserably. In introducing the bill in the Senate, Alan Cranston commented:

...the Banking Committee along with the Congress has been studying and mulling over the issues in this bill since such legislation evolved from the Hunt Commission study and recommendations in 1971, on needed improvements in the structure of financial institutions to move toward freedom and competition in the financial markets. The Senate has passed two bills on this subject and numerous hearings have been held in the House and Senate on these issues, however, the issues still remain with us.⁷³

⁷¹ Jimmy Carter, “Financial Reform Legislation Message to the Congress Proposing the Legislation,” May 22, 1979, *Weekly Compilation of Presidential Documents* 15928-930.

⁷² Judith Miller, “Carter Bids to Lift Bank-Interest Curb,” *The New York Times*, May 23, 1979, D12, ProQuest Historical Newspapers The New York Times (1851 - 2005).

⁷³ *Depository Institutions Deregulation Act of 1979*, S. 1347, 96th Congress, 1st session, *Congressional Record* 125, (June 14, 1979):14887. Cranston, a Democrat from California, introduced the bill for himself and for William Proxmire, a Democrat from Wisconsin and Chairman of the Senate Banking Committee.

The Senate bill, S1347, co-sponsored by Alan Cranston and William Proxmire, contained almost all of Carter's suggested reforms. Testifying before the Senate Subcommittee on Financial Institutions, Carter's Secretary of the Treasury, Michael Blumenthal, expressed "our appreciation for that initiative, which is very much along the lines of what the President is suggesting."⁷⁴ The bill, which was referred to the Senate banking committee, proposed authorization of share draft accounts, remote service units and automatic funds transfer to address the problems created by the Washington D.C. appellate court decision; permission for all federal institutions to offer NOW accounts; gradual phase-out of Regulation Q interest rate ceilings over a 10-year period; diversification of thrift portfolios through consumer lending, commercial paper, and trust services; and variable rate mortgages. The House bill was sparse compared to the Senate version. Introduced on July 27, it too formally legalized the regulations set aside by the April 20 Washington D. C. Appellate Court decision. It also permitted federal institutions nation-wide to offer NOW accounts. However, it did not address other issues such as interest rate ceilings and asset powers. Many witnesses who testified before the House Subcommittee on Financial Institutions recommended such measures, but witnesses such as Irvine Sprague, Chairman of the FDIC, urged the committee to keep the bill simple so as to ensure success.⁷⁵ Orin Kramer suggests that the House bill may have been so bare compared to the Senate version because the head of the House Banking Committee, Ferdinand St. Germain, was so heavily supported by the thrift industry, which generally objected to the

⁷⁴ Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Financial Institutions Hearing, *Depository Institutions Deregulation Act of 1979*, 96th Congress, 1st session, June 21, 1979, 96.

⁷⁵ House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation, and Insurance, Hearing, *Consumer Checking Account Equity Act of 1979*, 96th Congress, 1st session, May 15, 1979, 71-73; *Update on Consumer Checking Account Equity Act of 1979* H.R. 3864, 96th Congress, 1st session, *Congressional Record* 125 (July 16, 1979): 18837; *Consumer Checking Account Equity Act of 1979* 96th Congress, 1st session, *Congressional Record* 125 (September 11, 1979): 24026.

legislation. On the other hand, William Proxmire, co-chair of the Senate Banking Committee “thought about larger policy issues – not about special interests.”⁷⁶ The House passed its version of the bill, HR 4986, originally called the Consumer Checking Equity Act, on September 11, 1979, by a margin of 367 to 39.⁷⁷

During hearings before the Senate Subcommittee on Financial Institutions, all the major regulators supported the Senate bill, including the National Credit Union Administration, the Federal Reserve, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Federal Home Loan Bank Board. However, Anita Miller of the Federal Home Loan Bank Board seemed the most uneasy about potential effects of the legislation on savings and loan institutions. She offered a list of concerns about the reform package, emphasizing that bidding wars might cause savings and loans “to pay interest rates well above what they could afford.” Earnings in general could represent a problem, she explained. Savings and loans were indeed granted the right to offer new income-generating services to help offset the higher rates of interest they would pay for deposits as the phase-out of interest rate ceilings progressed. However, it would take time, she worried, for institutions to establish and market these new services, and S&Ls had already suffered from low earnings and declining net worth during recent periods of high inflation and interest rates. It was key, she testified that the Bank Board have some flexibility in phasing out interest rate ceilings: “It is our belief that any phasing out that mandates rigid precision in terms of timing and does not permit the

⁷⁶ Orin Kramer, interviewed by Jill S. Huerta, September 17, 2008. Though most of the S&L industry opposed the legislation because of its phaseout of Regulation Q rate ceilings, Kramer notes that a small number of larger thrifts supported the bill because they were more progressive in their thinking and wanted to compete for deposit funds.

⁷⁷ *Consumer Checking Account Equity Act of 1979*, H.R. 3864, 96th Congress, 1st session, *Congressional Record* 125 (September 11, 1979): 24026.

regulators wide flexibility, might well create serious problems with respect to financial solvency.”⁷⁸

Professional associations for banks, credit unions, mutual savings banks, and savings and loans supported the bill, though a bit less enthusiastically than the regulators. All the branches of banking, except for credit unions, seemed concerned about losing competitive advantage to another segment, and squabbled over the details of who would be granted what new powers. For example, the American Bankers Association opposed the timetable called for “which would substantially defer the time when commercial banks would attain the ability to compete fairly with thrift institutions.” Thrifts that offered transaction accounts should have to immediately give up the ¼% housing differential on rates paid to depositors, the ABA argued, not maintain it over the 10-year phase-out period stipulated in the bill. Since the bill provided that interest rate caps be raised in increments, thrifts should not be permitted new asset powers until the first rise in interest rates, two years after enactment of the bill, the ABA claimed. Also, they wanted to see rates begin to rise immediately, rather than in two years.⁷⁹

Savings and loans, of course, made exactly the opposite argument. Norman Strunk, Executive Vice President of the United States League of Savings and Loan Associations, warned of the difficulty thrifts would encounter in raising deposit rates to

⁷⁸ Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, Hearing, *Depository Institutions Deregulation Act of 1979, Part 2*, 96th Congress, 1st session, June 27, 1979, 32. Miller’s concerns were also echoed by Charles Partee, Member of Board of Governors of the Federal Reserve when he testified before the House Subcommittee on Financial Institutions. He argued that NOW accounts needed interest rate ceilings to keep costs under control and prevent earnings problems, which would hurt thrifts considerably. House Committee on Banking, Finance, and Urban Affairs, Subcommittee on Financial Institutions, *Consumer Checking Account Equity Act of 1979*, 96th Congress, 1st session, May 15, 1979, 86-91.

⁷⁹ Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, Hearing, *Depository Institutions Deregulation Act of 1979, Part 2*, 96th Congress, 1st session, June 27, 1979, 131.

market levels. Citing the nationwide mortgage portfolio yield at 8%, with considerably lower yields in the northeast, Strunk echoed the Federal Home Loan Bank Board's concern that paying market rates of interest would squeeze profits too severely. The industry's preference was for a bill that allowed rates to be adjusted both upwards and downwards over the ten year period, "moving to market level deposit rates within a ceiling framework with a rubberband, if you will, instead of a ratchet." He also lauded the bill's "ten-year continuation of Regulation Q," making the same argument the industry had made for years: that Regulation Q and the differential were essential to the savings and loan industry and to the U.S. housing industry. The industry could not do without Regulation Q, he argued, unless thrifts were given commercial bank powers or the ability to write renewal rollover mortgages. Strunk credited Regulation Q for the industry's continued success in the face of inflation and high interest rates: "Foremost among the mechanisms for stability in home finance has been the Regulation Q system and the savings rate differential. Despite our marked inferiority in service powers and convenience locations, the differential has enabled savings and loan associations to maintain generally our share of the savings market, though the banks' passbook share has grown." Interestingly, Strunk also pointed out that one fifth of savings in S&Ls were already earning market rates of interest through money market certificates, though he did not see MMCs as key to the industry's success. Regulators, competitors in the banking industry, and the Carter administration, of course, did not share this opinion about the usefulness of interest rate caps and the differential.⁸⁰

⁸⁰ Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Financial Institutions, Hearing, *Depository Institutions Deregulation Act of 1979, Part 2*, 96th Congress, 1st session, June 27, 1979, 177-203. Quotes from 177, 198, 183.

James Hagerty, testifying for the National Savings and Loan League, an alternative professional association, agreed with the need for flexibility in phasing out Regulation Q. He too emphasized that the industry already paid market rates of interest on much of its savings and argued that the transition to market rates was proceeding quickly enough on its own:

The message I want to leave the committee today is that the process of phasing out regulation Q is already well underway and is moving very rapidly. The actions of the regulatory agencies to eliminate the differential on IRA and Keough plans, the introduction of money market certificates and the recent change in rates and introduction of money market certificates and the recent change in rates indicate a lessening of the value of regulation Q. With marketplace and regulatory actions eroding regulation Q, we question the need for any legislative stimulus to speed up this process.⁸¹

Hagerty agreed with Strunk that the new powers granted to S&Ls by the bill were inadequate to create equal competition with commercial banks.⁸²

The National Association of Mutual Savings Banks also testified that the Senate bill did not do nearly enough to level the playing field between mutual savings banks and commercial banks. Phasing out regulation Q and the differential would put mutual savings banks at a severe competitive disadvantage to commercial banks. In order to abolish the differential, argued their president, mutual savings banks should be granted commercial bank powers.⁸³

On October 25, the banking committee reported the bill to the Senate, which passed it on November 1, 1979 by a vote of 76 to 9. On November 7, the House agreed to go to conference with the Senate to reconcile the two versions of the bill, which

⁸¹ Ibid., 249-251.

⁸² Ibid., 251.

⁸³ Ibid., 165-169.

differed significantly. They also chose to combine H.R. 4986 with another bill, H.R. 7, the Monetary Control Act, arguably because of the two bills' shared vital importance to the stability of the financial system. Rousselot, a Republican from California expressed great frustration that the Senate had "Christmas treed" the House version of the bill. Reuss a Democrat from Wisconsin argued that the conference would alleviate this problem, "What we do today is a kind of machete to cut off these extraneous Christmas tree limbs that the Senate has unfortunately put on the Consumer Equity Act." Rousselot, however, did not seem reassured, "What bothers me the most is that we somehow will be put in the position at the last minute of voting for something that comes out of this proposed conference far beyond the scope of these two bills that passed the House." He was especially concerned because the Washington D.C. appellate court decision made it vital that legislation be passed before the end of the year to protect the ability to offer share drafts, remote service units, and automatic funds transfer. "I just felt we should have this understanding so that we are not put in the position of a last-minute fire sale, as it were; that we have to take it the way it is because we are up against a deadline."⁸⁴ As it turned out, Rousselot need not worry about the pressure of the deadline. On December 28, 1979, Congress legitimized share drafts, automated transfer of funds, and remote service units until March 31, 1980 to give itself a bit more time to consider the legislation.

As the bill went through Congress, the Carter administration continued to work hard to promote it. They collaborated closely with the American Bankers Association, reflected in a thank-you letter sent to the organization's president which expressed that

⁸⁴ *Depository Institutions Deregulation Act of 1979*, H.R. 4986, 96th Congress, 1st session, *Congressional Record* 125 (November 7, 1979): 31326-31327.

“The Association’s Washington staff has been extremely helpful in assisting us in designing what I hope will be perceived as an equitable and rational package...we should work closely together this summer.”⁸⁵ Larger banks, along with some large S&Ls, eagerly supported the legislation, hoping for the chance to compete with money market funds for deposits and to offer variable rate mortgages.⁸⁶

Much opposition to the bill came from the savings and loan industry, and Carter’s staff engaged in extensive behind-the-scenes work to convince key members of Congress to support the bill despite pressure from the thrift industry in their states to oppose it. For example, when the financial reform bill was in the Senate Banking Committee, Orin Kramer suggested that Stu Eizenstat phone Senator Alan Cranston “who is coming under pressure from California thrifts (the nation’s largest), which seek perpetuation of the ceilings and the ¼ point differential into perpetuity.” Among the talking points provided to Eizenstat, Kramer suggested that he reassure the Senator that “We understand his sensitivity to the concerns of the savings and loan industry, and we are willing to accommodate that concern.”⁸⁷ The administration was indeed willing to compromise with the S&L industry if necessary, offering to make the terms of the Regulation Q phase-out more flexible. However, Eizenstat was instructed to make it clear that “There are limits to how far we can go to accommodate the thrifts.” The administration had to walk a fine line between efforts to get S&Ls on board and losing the support of bankers and others, such as consumer and elderly groups, who had already become impatient with

⁸⁵ Letter from Orin S. Kramer to John H. Perkins, June 18, 1979, Box 154, White House Staff Files: Domestic Policy Staff, Jimmy Carter Presidential Library.

⁸⁶ Orin Kramer phone interview by Jill S. Huerta, September 17, 2008.

⁸⁷ Memorandum from Orin Kramer to Stu Eizenstat, “Telephone Call on Regulation Q,” September 10, 1979, Regulation Q—Banking, Box 268, Staff Office Files: Domestic Policy Staff, Eizenstat Jimmy Carter Presidential Library; According to Orin Kramer, Senator Cranston was “owned and operated by the savings and loan industry.” Orin Kramer phone interview by Jill S. Huerta, September 17, 2008.

the idea of such a gradual, prolonged phase-out of rate ceilings.⁸⁸ Kramer also asked Eizenstat to call Donald Riegle and Paul Sarbanes, two undecided members of the Senate Banking Committee, to relay to them that “this is one of the few deregulation bills which can be enacted this year and where the public benefits are readily understandable, we would hope to be able to work together on this bill.” Eizenstat clearly agreed with this strategy, noting on the memo that he would call “asap.”⁸⁹ In October of 1979, after the Senate Banking Committee had reported almost all the legislation suggested by Carter the previous May, Kramer and Eizenstat suggested Senate Liason Dan Tate call Senate Majority Leader Byrd to convince him to schedule time for the bill on the Senate floor, despite savings and loan opposition expressed by Senator Morgan. Again the talking points included the fact that “of all the President’s deregulation proposals, this is the only one which has a chance of passing either house this year,” and that despite thrift opposition to lifting rate ceilings, the benefits of this to small savers “would be readily comprehensible to the public.”⁹⁰

At the end of February 1980, when DIDMCA was in conference, the administration still involved itself heavily in the legislative effort. As was the administration’s habit, the final push was made by the Domestic Policy Staff. In a memo to Eizenstat, Kramer reported “We have reached agreement with Proxmire, Reuss and St. Germaine on the elements of the bill.” However, “The problem is that over the past day Senator Cranston has threatened to withdraw his support for the package, which would

⁸⁸ In fact, in 1978, consumer groups sued regulators for creating accounts with high minimum deposit levels that discriminated against small savers. See David Mason 214-215.

⁸⁹ Memorandum from Orin Kramer to Stu Eizenstat, “Telephone Call on Regulation Q,” September 10, 1979, Regulation Q-Banking, Box 268, Staff Office Files: Domestic Policy Staff – Eizenstat, Jimmy Carter Presidential Library.

⁹⁰ Memorandum for Dan Tate from Stu Eizenstat and Orin Kramer, “Senator Byrd and Regulation Q,” October 19, 1979, Regulation Q—Banking, Box 268, Staff Office Files: Domestic Policy Staff – Eizenstat, Jimmy Carter Presidential Library.

splinter our fragile coalition.” Kramer suggested that Eizenstat attend a meeting between Deputy Secretary of the Treasury Carswell and Cranston, in hopes of winning over the Senator’s support.⁹¹

Stu Eizenstat’s letter replying to Tony Frank, Chairman of a large California savings and loan, also indicates that the Administration was aware of and perhaps involved in negotiations taking place while the bill was in conference. Eizenstat’s letter responded to Frank’s call for “some quick remedial action” to deal with the savings and loan crisis. Eizenstat’s response assured Frank that “We are expeditiously reviewing a number of actions, including those you recommend, as well as others (for example, increasing the level of Federal insurance).”⁹² Carter had never asked for an increase in the limit of deposit insurance. The savings and loan industry wanted this provision, and it had been recommended by the Board of the U.S. League in May of 1979. However, neither the House nor the Senate version of DIDMCA incorporated it. The fact that Eizenstat knew about this compromise that was made during the conference proceedings, but had not yet been made public, indicates that the administration was still intimately involved in tailoring and marketing the bill. Such diligent effort from beginning to end and willingness to compromise obviously helped immensely in finally securing passage of a financial reform bill.

On March 27, 1980, the conference report on H.R. 4986, the Depository Institutions Deregulation and Monetary Control Act, was presented in both the House and the Senate. The final version of the bill was indeed omnibus legislation, representing the

⁹¹ Memo from Orin Kramer to Stu Eizenstat, February 28, 1980, “Meeting with Senator Cranston” Regulation Q—Banking, Box 268, Staff Office Files: Domestic Policy Staff-Eizenstat, Jimmy Carter Presidential Library.

⁹² Letter from Stuart Eizenstat to Tony Frank, March 7, 1980, Banking Deregulation, Box 3, White House Central Files: Stu Eizenstat, Jimmy Carter Presidential Library.

most comprehensive reform of the U.S. financial system since the New Deal. It applied to federally chartered commercial banks, mutual savings banks, savings and loans, and credit unions. It addressed liabilities, assets, monetary policy, consumer protection, and international banking. The product of almost 10 years of effort, the bill embodied the demands and compromises of all interested parties. On the liability side, DIDMCA gave all depository institutions the right to offer transaction accounts, authorizing NOW accounts nation-wide for individuals. It also addressed the Washington D. C. appellate court decision by legalizing the use of share draft accounts by credit unions, remote service units by savings and loans, and automatic funds transfer by commercial banks. This gave all segments of banking the right to offer an interest-earning transactions account. DIDMCA called for the phasing out of Regulation Q interest rate ceilings over a 6-year period, rather than the ten-year period provided for in the Senate version of the bill. This made the bill more palatable to consumer groups and to bankers, who wanted a swift removal of interest rate ceilings and the differential. In a nod to the savings and loan industry, the differential was to remain intact during the phase-out. Decontrol of interest rates was to be accomplished by a Depository Institutions Deregulation Committee (DIDC), consisting of the Board of Governors of the Federal Reserve, Chairman of the Board of Directors of the FDIC, the Chairman of the FHLBB, and the Chairman of the National Credit Union Association (NCUA) Board. The Comptroller of the Currency was to serve on the Committee as well, but as a nonvoting member. DIDMCA gave the committee the authority to set Regulation Q interest rate ceilings for six years, with the directive to phase out controls as "rapidly as economic conditions warrant." Congress also required the Committee to present it with annual reports

regarding the need for an interest rate differential between thrifts and banks, means for encouraging savings, disintermediation to money market funds, and legislative and regulatory suggestions.⁹³

In terms of monetary policy, DIDMCA required that all institutions offering transaction or non-personal time accounts keep reserves in the Federal Reserve System. This applied to Fed members and non-members alike. The act also gave the Fed the authority to require supplemental reserves if necessary to conduct monetary policy and allowed the Fed to pay interest on these supplemental reserves. Nonmembers of the Federal Reserve subject to reserve requirements were entitled, under DIDMCA, to the discount and borrowing benefits offered to Fed members. While the new reserve requirements expanded the number of institutions required to set aside reserves, they also lowered compulsory reserve levels, allowing the largest banks to take funds out of reserve and lend more money.⁹⁴

On the asset side, DIDMCA expanded investment options available to thrifts. The final act permitted federal savings and loans to invest up to 20% of assets in consumer loans, commercial paper, and corporate debt securities. The law also allowed S&Ls to offer credit cards and to exercise trust and fiduciary powers. The Senate version of the bill had set the limit at 10% of assets. S&Ls were also freed from previous geographic

⁹³ The Library of Congress, Thomas, "H.R. 4986" <http://thomas.loc.gov/cgi-bin/bdquery/D?d096:1:/temp/~bduwxa:@/@/L&summ2=m&/bss/96search.html> accessed 4/10/08.

⁹⁴ Bank of America, the largest bank at the time gained \$1.2 billion for investments because of this provision, while Citibank and Chase Manhattan each gained \$450 million. Charles R. Babcock, "The Banking 'Reform' Bill: Parceling Out the Goodies," *The Washington Post* April 15, 1980, A2, www.lexisnexis.com.proxy2.cl.msu.edu:2047/us/inacademic/deli accessed July 22, 2008; Paul Allen and William Wilhelm argue that this leveling of reserve requirements changed the relative competitive balance in banking eliminating "a comparative burden for FRS [Federal Reserve System] banks relative to other depository institutions." Paul R. Allen and William J. Wilhelm, "The Impact of the 1980 Depository Institutions Deregulation and Monetary Control Act on Market Value and Risk: Evidence from the Capital Markets," *Journal of Money, Credit and Banking*, Vol. 20, No.3, Part 1, (Aug., 1988) 367 <http://www.jstor.org/stable/1992262> accessed 3/27/08.

and value limits in writing mortgages. Federal mutual savings banks were granted greater investment latitude as well, with authorization to invest up to 5% of assets in commercial, corporate, and business loans made within the home state or within 75 miles of the home office.⁹⁵

DIDMCA also sought to make loan-writing profitable under the high interest rates of 1980 by pre-empting state usury laws on first mortgages and on business and agriculture loans over \$25,000. States could override the preemption and re-impose usury limits as long as they did so within 3 years. The legislation also preempted state usury ceilings on other lending, such as consumer and home equity loans, made by state chartered federally insured banks, S&Ls, and credit unions. Rates for these loans were instead set at 1% above the Fed discount rate. National banks already had this privilege. States could override this preemption at any time by simply passing a law or referendum. The law also raised the maximum rate that credit unions could charge on loans.⁹⁶

To improve net worth, DIDMCA allowed thrifts to issue mutual capital certificates to raise capital towards their net worth. This was a compromise to savings and loans. It was part of the recommendations made by the U.S. League of Savings Associations on May 1, 1979, before Carter had sent his reform address to Congress.⁹⁷

Perhaps the most controversial provision in the final bill was the raising of the limit on deposit insurance from \$40,000 to \$100,000 per account.⁹⁸ Neither the House nor the Senate bill contained such a provision. It was agreed to during the conference, as

⁹⁵ The Library of Congress, Thomas, "H.R. 4986" <http://thomas.loc.gov/cgi-bin/bdquery/D?d096:l:/temp/~bduwxa:@/@L&summ2=m&/bss/96search.html> accessed 4/10/08.

⁹⁶ Ibid.

⁹⁷ Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Financial Institutions, *Depository Institutions Deregulation Act of 1979, Part 2*, 96th Congress, 1st session, June 27, 1979, 187-189.

⁹⁸ Ibid.

a compromise to savings and loans for loss of the interest rate differential. Like the mutual capital certificates, it was one of the recommendations of the U.S. League of Savings Associations when it met on May 1. According to Martin Mayer, the conference was on the verge of failing when the California savings and loans, assisted by their Senator, Alan Cranston, agreed to withdraw their objections if the rise in deposit insurance was included in the legislation.⁹⁹ Former economist for the Senate banking committee, Robert Dugger, notes that he was in the room when Cranston brokered this deal. He backs Mayer's account that S&Ls agreed to accept the phaseout of Regulation Q if the limit on deposit insurance was increased. This would allow S&Ls, especially the large California associations, to take in more brokered deposits and try to "grow out of their problems."¹⁰⁰ Cranston had reason to negotiate on behalf of savings and loans. A significant number of S&Ls had contributed funds to his 1979-1980 political campaign, as had the U.S. League of Savings Associations, the National League of Savings Associations, and the Savings and Loan League of California. Several banks, the American Bankers Association, and the California Bankers Association had supported Cranston as well. Thus, he had motive to make sure the legislation passed, since bankers had supported the elimination of rate ceilings and the differential for some time.¹⁰¹ The deal was made, and all interested parties gave their approval and support, including the Community Bankers Division of the American Bankers Association, the United State

⁹⁹ Martin Mayer, 94. In his memoir, former head of the FDIC, L. William Seidman also credited the chairmen of the Senate and House Banking Committees, William Proxmire and Henry Reuss, for the provision. He asserts that, "It was a bipartisan effort, done at a late-night conference committee meeting, with none of the normal reviews by the press and public. No doubt the members of the committee were fully aware of the political power of the S&Ls, but the fact is, the legislation was passed with little thought of what its full effect could be." See L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (Times Books, 1993) 179.

¹⁰⁰ Interview with Robert H. Dugger by Jill S. Huerta, November 21, 2008.

¹⁰¹ Federal Election Commission, *1979-1980 Candidate Index of Supporting Documents – Alan Cranston* printed July 6, 2005.

League of Savings Associations, the National Savings & Loan League, the National Association of Mutual Savings Banks, the Credit Union National Association, and the National Association of Federal Credit Unions.¹⁰²

Carter signed DIDMCA into law on March 31, 1980, calling it “a landmark financial reform bill” and “another step in a long but extremely important move toward deregulation by the Federal Government of the private enterprise system of our country.”¹⁰³ The legislation was indeed necessary and long overdue. The inflation and high interest rates of the late 1960s and 1970s had finally revealed the flaws inherent in the New Deal regulatory framework for banking. Borrowing short and lending long had steered savings and loans into earnings trouble. Furthermore, technological innovation had made a balkanized banking industry obsolete and all but impossible to maintain. American depositors voted with their money against discrete banking segments and interest rate caps. If the financial industry would not accommodate their demands for convenience and reasonable rates of interest, they would move their money elsewhere. This transfer of personal savings out of depository institutions and into the investment market stood to severely damage the nation’s savings and loans, commercial banks, mutual savings banks, and credit unions. Perhaps more importantly, it threatened to change the allocation of credit in the U.S. economy. While money market funds invested in government securities and a limited range of commercial stock, depository institutions

¹⁰² *Conference Report on; HR4986 Depository Institutions Deregulation and Monetary Control Act of 1980*, H.R. 4986, 96th Congress, 2nd session, *Congressional Record* 126 (March 27, 1980): 6965-6985.

¹⁰³ Jimmy Carter, “Remarks on Signing H.R. 4986 Into Law,” *Weekly Compilation of Presidential Documents* Volume 16, Number 14 March 31, 1980, 572-574.

tended to invest in housing, agriculture, and small business.¹⁰⁴ A credit crunch in those markets was highly undesirable, especially during a time of slow economic growth. Some kind of deregulatory effort was needed and DIDMCA was a sound effort.

Unfortunately, the effort came a bit late. By 1980, the Fed's attack on inflation had driven up interest rates to unprecedented heights, making it a rather difficult time to begin the process of eliminating interest rate ceilings. Recall that the Friend Study had recommended that rate ceilings be gradually phased out "in a period when credit is easy and market interest rates are declining appreciably."¹⁰⁵ In the high rate environment of the early 1980s, it would be difficult for depository institutions to pay market rates of interest. This was especially true for savings and loans because of the nature of their investment portfolios. While commercial banks had investments of varying maturities, S&Ls assets were still mainly long term home loans, written at the lower rates of the past. The interest payments from these loans did not generate enough income to support high payments of interest on deposits. The potential danger was a further squeeze in earnings. DIDMCA called for an expansion of S&L asset powers to try to counteract this problem, but implementing new investment powers took time and money, and posed a significant challenge during this era of low earnings. Clearly, deregulation of interest rate controls and expansion of asset powers would have been far easier to achieve over a decade earlier, when the Friend Study recommended such actions.

¹⁰⁴ Paul Volcker testified about this difference in credit allocation before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, *Depository Institutions Deregulation Committee*, 96th Congress, 2nd session, August 5, 1980, 8-10.

¹⁰⁵ Irwin Friend, "Summary and Recommendations: A part of the Study of the Savings and Loan Industry" in *Study of the Savings and Loan Industry, Prepared for the Federal Home Loan Bank Board* (U.S. Government Printing Office, 1969) 29-30.

However, as explained above, securing the passage of deregulatory legislation proved to be a formidable task that took over a decade to achieve. Though large banks and a number of large S&Ls supported the legislation, it was strongly opposed by most S&Ls and small banks. Building agreement among the various groups took an enormous amount of work and compromise since both bankers and S&Ls seemed to have tremendous political influence. The push and pull of negotiations resulted in the inclusion of an unfortunate provision in the final legislation. During a time when the average depositor had \$6,000 in their savings account, the increase in the limit on deposit insurance from \$40,000 to \$100,000 was both unnecessary and undesirable. It allowed troubled S&Ls to raise an enormous amount of capital from brokered deposits, which they could invest in a number of new ways. The risks of these new investments were, of course, underwritten by U.S. taxpayers. However, without this provision, it is unlikely that the legislation would have succeeded.

One interesting aspect of this legislative effort is the degree to which negotiations among competing groups took place outside of the legislative process. Financial deregulation was contentious legislation, so contentious that it took more than a decade to accomplish. However, this was not reflected in the votes of the House and Senate, which were not close. Special interests kept this bill from reaching the Senate and House floors until all the interested parties were satisfied with the product. By the time Congress voted, most of the major provisions had been agreed upon. The ones that remained were settled in conference or in private, off the record, as was the case with the increase in the limit on deposit insurance. The process was decidedly undemocratic.

Overall, the legislative effort was clearly a success at its moment of passage. All the interested parties both benefited and compromised. Depository institutions needed the ability to offer customers a variety of convenient and interest-paying services in order to compete with each other. DIDMCA gave them this power. Depository institutions needed the ability to pay market rates of interest in order to compete with other investments for private savings. DIDMCA gave them that this ability. S&Ls needed to begin diversifying their investment portfolios in order to weather periods of high interest rates. DIDMCA gave them the chance to diversify. DIDMCA also protected the integrity of the Federal Reserve System, enhanced the ability of depository institutions to write mortgages in all states, and helped small savers begin to earn a fair return on their deposits during a time of skyrocketing inflation. After a long struggle, the American banking system finally began to modernize and rationalize itself to meet the demands that a changing world economy had placed on it. The question to be answered in the future was whether this initiative would prove to be too little too late.

CHAPTER 4

MORE DEREGULATION

The passage of DIDMCA did not end the jostling for competitive advantage that had come to characterize the financial industry. On the contrary, attempts to work the system for benefits continued, and controversy abounded as the newly created Depository Institutions Deregulation Committee set about its job of phasing out ceilings on deposit rates. The independent committee, created under DIDMCA, was composed of the Secretary of the Treasury, the Chairman of the Fed, the Chairman of the FDIC, the Chairman of the FHLBB, the Chairman of the National Credit Union Administration Board, and the Comptroller of the Currency, who acted as a non-voting member. DIDMCA was given the authority to set interest rate ceilings, with a directive to phase out the ceilings “as rapidly as economic conditions warrant,” though the legislation stipulated that all interest rate ceilings be eliminated within 6 years of the enactment of the legislation.¹ During a May 28 meeting, less than two months after the passage of DIDMCA, the committee took decisive action with regard to interest rate ceilings and the differential for money market and small saver certificates. Though DIDMCA called for a gradual six-year phase-out of interest rate ceilings and the differential, the committee took a rather sudden step towards that goal.²

¹ Library of Congress, Thomas, “H.R. 3864” <http://thomas.loc.gov/cgi-bin/bdquery/D?d096:l:/temp/~bdf3Rm:@/@L&summ2=m&/bss/d096query.html#titles> accessed 3/9/09.

² Depository Institutions Deregulation Committee Press Release, May 29, 1980, Depository Institutions Deregulation Committee, Box 74, Council of Economic Advisors, Charles L. Schultze, Jimmy Carter Presidential Library.

With regard to the money market certificate, an instrument created in 1978 carrying a rate that floated with the six-month Treasury bill, DIDC narrowed the circumstances under which thrifts could pay a ¼% differential over rates commercial banks could pay. Before the action, thrifts were permitted to pay a differential of varying amount anytime Treasury rates fell below 9%. Under the new rules, the differential would apply only when the Treasury bill rate fell between 7 ¼% and 8 ¾%. Otherwise, all depository institutions would pay the same rate of return, which was set at ¼% higher than the 6-month Treasury bill rate. The committee also created a minimum ceiling for money market certificates of 7 ¾%, meaning that even when the Treasury rate dipped lower, thrifts and commercial banks had the option of continuing to offer the minimum. Finally, the committee eliminated the differential on one-time renewals, allowing banks to roll over existing money market certificates with their depositors at the thrift rates even when the differential would ordinarily apply.³

DIDC also provided for new rates on small saver certificates. Created in 1979, small saver certificates carried no minimum denomination requirements, matured in 30 months or more, and offered interest rates that fluctuated with Treasury bills of similar maturities. DIDC raised rates on small saver certificates by ½%, allowing thrifts to pay the same rate as the Treasury paid for 2 ½ year securities, and permitting commercial banks to offer ¼% less than thrifts. However, the committee capped the allowable rate at 12% for thrifts and 11 ¾% for banks. Thus, even when Treasury rates moved above

³ Depository Institutions Deregulation Committee Press Release, May 29, 1980, Depository Institutions Deregulation Committee, Box 74, Council of Economic Advisors, Charles L. Schultze, Jimmy Carter Presidential Library; Memo to Charlie Schultze from Burke Dillon, May 30, 1980, "New MMC and Small Saver Deposit Ceilings," Depository Institutions Deregulation Committee, Box 74, Staff Office Files: Council of Economic Advisors, Charles L. Schultze,, Jimmy Carter Presidential Library; Nancy L. Ross, "Interest Ceilings Compromise; A Rube Goldberg Compromise on Certificate Rates; Winners, Losers on Rate Changes" *The Washington Post* May 30, 1980, www.lexisnexis.com, accessed 1/9/09.

those levels, institutions could not pay more on small saver certificates. DIDC also created a minimum ceiling for small saver certificates of 9.25% for commercial banks and 9.5% for thrifts. This meant that thrifts and commercial banks had the option, though not the obligation, of offering 9.25% even when Treasury bill rates dropped below the point where the pegged rates for these institutions would be 9.25%. DIDC also increased the penalties assessed for early withdrawal of time deposits such that the penalty could exceed interest earned and actually reduce principal balances.⁴

DIDC's actions proved extremely controversial. By June 17, the U.S. League of Savings Associations filed suit against the committee in U.S. District Court, hoping the court would restore the differential. The League claimed that DIDC's actions would stall recovery of the housing market by reducing the funds available for mortgage loans. As a result of the committee's adjustments, savings and loans would lose more than \$17 billion in savings inflows over the next 6 months, the League argued.⁵ The American Bankers Association severely criticized the savings and loan industry and the League in particular for filling newspapers "with new predictions of gloom and doom every day." Banks pointed out that they wrote 21% of new mortgages, thus housing funds were not necessarily jeopardized by the action.⁶

The decisions of the DIDC also caused serious political problems for the Carter administration. In June of 1980, the Associate Director of Carter's Domestic Policy Staff (DPS), Orin Kramer, sent a memo to Stu Eizenstat, the department director, outlining the

⁴ Ibid., 3-4.

⁵ Clyde H. Farnsworth, "Savings Group Asserts Rate Rules Hurt Housing," *The New York Times*, June 5, 1980 ProQuest Historical Newspapers The New York Times (1851 - 2005); Nancy L. Ross, "S&Ls File Suit To Get Higher Interest Rates," *The Washington Post*, June 17, 1980 www.lexisnexis.com accessed 1/24/2009.

⁶ Merrill Brown, "ABA Hits Thrifts' Criticism of Deregulation Movement," *The Washington Post*, July 2, 1980, www.lexisnexis.com.

political issues raised by DIDC's actions and discussing how the administration should handle them. In responding to thrift complaints, Kramer suggested that the administration "attempt to walk a fine line between expressing sympathy for the thrifts' problems and avoiding criticism of Secretary Miller and the DIDC." In his own evaluation of the action, Kramer criticized DIDC for its unnecessarily complex scheme, complaining that, "a system this convoluted could only be devised as a political compromise by a committee." However, he called the overall plan a "mixed bag," highlighting several benefits, including that the actions would "assure thrifts of substantial inflows in the coming months." Another benefit, which "only the most sophisticated thrifts recognize," is that interest rate floors set by the committee meant that when Treasury bill rates fell below 7.75%, thrifts and banks would be more competitive against money market funds. This was a chance to win the battle with investment banks, which administered money market mutual funds. Yet thrifts would not see it this way, according to Kramer. Even though Treasury bill rates did not represent "true market rates on \$10,000 denominations," Kramer explained, thrifts perceived that they did. "From the thrift perspective, the regulators have forced the yield above market rates on an instrument that represents 40% of thrift deposits."⁷

Continuing to explain thrift misperceptions of their environment, Kramer expressed that, "[t]he underlying difficulty, in my view, is that most thrifts have not come to grips with the implications of the deregulation act, which stipulates that all rates should eventually be set by the market." He was not, however, unsympathetic to the earnings problems S&Ls would face in paying market rates of interest in the midst of such

⁷ Memo from Orin Kramer to Stu Eizenstat, June 27, 1980, "Depository Institutions Deregulation Committee" Banking Deregulation, Box 3, Staff Office Files: Domestic Policy Staff-Eizenstat, Jimmy Carter Presidential Library.

difficult economic conditions. "...many will be unable to afford to do so, and a contraction in the number of thrift institutions and reduced profit margins are probably inevitable unless inflation abates."⁸

Kramer's memo also sheds light on DIDC's relationship with the administration. While there was at least some degree of corroboration between the two, the DIDC seems to have been, for the most part, independent. For example, DIDC apparently accommodated the administration by retaining the thrift interest rate differential in some cases. At the same time, Kramer felt that DIDC somewhat betrayed that agreement:

...when Secretary Miller agreed with you not to eliminate the differential below 9%, in my view it somewhat stretched the spirit of that agreement to retain the differential in the narrow 7.75-8.75% band for new deposits only, but to eliminate it under all other conditions. Since thrifts suffered without the differential above 9% with the clear understanding from the regulators that they would regain the differential under 9%, their sense of betrayal is understandable.⁹

Even though Kramer agreed that "the principle of deregulation is correct and ultimately beneficial to depository institutions," he felt, "less than enthusiastic about seeing that principle implemented so forcefully and rapidly in an election year." He went on to assert that "It is critically important that the DIDC avoid controversy in the coming months."¹⁰

While Kramer claimed he would try to get a "controversial action for September" moved to November, he did not seem sure he could accomplish this and told Eizenstat that he would "come to you for help if necessary." While the administration had some ability to influence DIDC, that ability was apparently limited and DIDC obviously put Carter in a difficult political position.

⁸ Ibid.

⁹ Ibid.

¹⁰ Ibid.

Both the House and Senate Banking Committees took up the cause as well, holding hearings to evaluate DIDC's ruling. Another contentious aspect of the committee's actions lay in the nature of its proceedings. Meetings held on this issue on May 20 and 23 took place in secret and behind closed doors, despite DIDMCA's stipulation that they be public, complained the President of the League of Savings Associations, Edwin Brooks. While the May 28 meeting took place in public, it occurred after hours and the decisions made were not put to the test of a comment period that usually accompanied regulatory changes. Furthermore, Brooks argued that the DIDC gave insufficient notice of the changes which went into effect 3 days before the new rules became available in the *Federal Register*.¹¹ The President of the National Association of State Savings and Loan Supervisors, Walter Madsen, echoed these sentiments, calling the procedures a violation of the Sunshine Act.¹²

During the House hearings, several witnesses testified that DIDC disregarded the intent of DIDMCA because of a banking bias inherent in the committee, and because of pressure from the American Bankers Association. Not surprising, Edwin Brooks, president of the U.S. League of Savings Associations was one such witness who complained that the ABA had pressured the committee. He predicted that mortgage rates would surely increase as a result of DIDC's actions and that this would in turn hurt the homebuilding industry. Walter Madsen, President of the National Association of State Savings and Loan Supervisors, too felt that the committee was unduly influenced by banking interests, since it had two members who were representatives of the banking

¹¹ House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing, *Oversight Hearings on Depository Institutions Deregulation Committee*, 96th Congress, 2nd session, July 2, 1980, 30-31.

¹² *Ibid.*, August 26, 1980, 359.

industry. He urged that the Secretary of the Department of Housing and Urban Development (HUD) be added to the committee to represent housing interests and suggested that Congress give DIDC more specific guidelines as to how the phasing out of rate ceilings should proceed. The president of the National Association of Mutual Savings Banks also called for representation of HUD on the committee and the National Homebuilders Association supported this, as well as specific directives to the committee to keep the housing differential in force for the entire 6-year phase-out period.¹³

These witnesses were heavily supported by Ferdinand St. Germain, Democratic Chairman of the House banking committee, who argued that “The Congress is entitled to see that the laws it enacts are followed and that the basic intent of these acts is not distorted and changed by unseen and unelected bureaucrats hiding behind the pages of the Federal Register.”¹⁴ Frank Annunzio, a Democrat from Illinois, was particularly passionate in his objections to DIDC’s actions, asking, “[b]ut how can the home mortgage and homebuilding industries be treated fairly when the committee is dominated by card carrying commercial bank sympathizers.” He introduced a bill to do away with the committee all together and return the power to set rate ceilings to regulators.¹⁵ Annunzio might have been motivated by his supporters. He received campaign contributions from various members of the homebuilding industry, such as the Carpenters’ Legislative Improvement Committee, the Committee of the National

¹³ Ibid, July 2 and August 26, 1980.

¹⁴ Ibid., 2.

¹⁵ Ibid., 4.

Association of Home Builders, and the Title Industry Political Action Committee, as well as from North West Federal Savings and Loan.¹⁶

The ABA, of course, sung a different tune at the hearings, supporting both the committee's composition and its May 28 decisions. The important issue argued Richard Rosenthal, ABA banking advisor, was not competition between commercial banks and thrifts, but competition between depository institutions and unregulated financial markets. DIDC's decisions, he explained, made depository institutions more competitive with investments outside of the banking sector. Furthermore, he argued that the differential in favor of thrifts did not historically protect housing in tight credit markets and that many alternative means of housing finance had developed including funding by commercial banks, the secondary market, and government agencies. DIDC's decision, he characterized as a small step toward much needed deregulation that would allow banks to pay a larger role in housing and allow savings and loans to diversify their assets.¹⁷

Paul Volcker delivered a similar message in defending DIDC's decisions before the Senate banking committee in August. Like the ABA, Volcker claimed that the key issue lay not in competition among depository institutions, but in competition between depository institutions and alternate investments such as money market mutual funds. Thus, DIDC's actions with regard to raising rate ceilings and eliminating the differential on some investments should be viewed with regard to the committee's "central responsibility under the law as one of managing interest rate ceilings in a manner that supports the Nation's economic goals and prepares the way for ultimate

¹⁶ Federal Election Commission 1979-1980 Candidate Index of Supporting Documents, Frank Annunzio. Printed July 6, 2005.

¹⁷ House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing, *Oversight Hearings on Depository Institutions Deregulation Committee*, 96th Congress, 2nd session, July 2, 1980, 98-118.

deregulation...”¹⁸ Volcker also explained that pairing down the differential needed to be done to protect the soundness of some small commercial banks. Banks and thrifts had been paying the same rates for deposits for over a year. As rates dropped and the differential was about to be reinstated, small commercial banks, who had suffered from a drop in profitability under deregulated rates, stood to suffer much disintermediation, which would have compromised their ability to make important loans.¹⁹ In addition, Volcker justified DIDC’s establishment of minimum rate ceilings. These helped depository institutions compete, he argued, because Treasury rates, to which rate ceilings were keyed, tended to be lower than other available rates in the market and tended to decline first. Thus, depository institutions needed the ability to pay market rates even when Treasury rates fell in order to compete with alternative investments.²⁰

Lewis Odom, Deputy Comptroller of the Currency, heavily supported Volcker in his testimony, pointing out that many factors had to be balanced in managing the phase-out of Regulation Q. These included giving small savers market interest rates, helping regulated depository institutions to compete with non-regulated funds, ensuring fairness and soundness among depository institutions, and guaranteeing credit flows to important markets. DIDC, he believed was doing its job well.²¹

Jay Janis, Chairman of the FHLBB acknowledged the difficulties faced by DIDC in interpreting its mandate from Congress, instead of merely accusing the committee of favoritism toward banks. “The question of congressional intent regarding the differential, as it bears on past DIDC actions, is a matter of considerable debate, even among

¹⁸ Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, *Depository Institutions Deregulation Committee*, 96th Congress, 2nd session, August 5, 1980, 8-10.

¹⁹ *Ibid.*, 11.

²⁰ *Ibid.*

²¹ *Ibid.*, 36-38.

Members of the House and Senate, and is the subject of a lawsuit,” he explained. Given such uncertainty, he supported legislation setting rules on the fate of the differential during the six-year phase-out period. He did, of course, argue that thrifts needed the differential while they established the new services in which DIDMCA had permitted them to engage.²²

Senator Allen Cranston was less sympathetic than Janis, stating that DIDC’s decision had created an “unduly complex interest rate structure imposed without regard for a needed breaking-in period for the public and for financial institutions.”²³ Cranston had sent Volcker a letter on June 30 criticizing the committee’s May 28 decision and asking a host of questions about how and why the committee reached that decision. He urged Volcker “to reconsider the actions you have taken, for they may well be having unintended consequences.”²⁴

Ultimately, the court ruled that DIDC’s adjustment to rate ceilings was legal. The court did, however, criticize DIDC’s procedures of failing to give proper notice.²⁵ Part of the committee’s dilemma lay in the fact that interest rates continued rising to new heights after the passage of DIDMCA. Depository institutions clearly lost deposit funds to alternative investments such as money market mutual funds as market rates of interest rose faster than DIDC could remove ceilings. However, savings and loans argued that they could not afford to pay market interest rates on their deposits because their profitability was being so squeezed by their low yielding portfolios of mortgages written in the past. Though DIDMCA gave them new asset powers, those had not yet begun to

²² Ibid., 19-20.

²³ Ibid., 21.

²⁴ Ibid., 23.

²⁵ Andrew S. Carron, *The Plight of the Thrift Institutions* (Washington D.C: The Brookings Institution, 1982) 55-60.

generate profits. Banks, especially large ones, were more supportive of the DIDC's actions because their investment portfolios were more diversified than those of thrifts. At the same time, they were eager to offer higher rates of return because they were suffering from disintermediation as investment banks and foreign banks competed with them for deposits. While profitability proved to be the most pressing problem for S&Ls, competition was the most pressing problem for banks.²⁶ Perhaps the fallout from DIDMCA would have been less contentious if interest rates had dropped or even remained stable after the bill's passage. However, just the opposite occurred. By the end of 1980, Paul Volcker's assault on inflation drove the prime rate up to 20% and the federal funds rate reached 19%.²⁷ This strained the U.S. economy and worsened the financial condition of savings and loans, acting as a catalyst for the passage of more financial deregulation.²⁸

For example, disintermediation remained a problem after the passage of DIDMCA. The U.S. League reported that new savings for the first 8 months of 1980 were down 70% from those just a year earlier. The FHLBB also reported a massive drop in net income on assets in the first half of 1980, from .65% to .17%.²⁹ During the second half of 1980, 85% of S&Ls reported losses.³⁰ DIDMCA did not seem to forestall the coming industry crisis. Clearly more action was needed if the industry was to survive the high inflation and interest rates that accompanied Volcker's monetary policy. However, charting this course would be the job of a new administration.

²⁶ Donald D. Hester, "U.S. Banking in the Last Fifty Years," 12-13.

²⁷ Anthony S. Campagna, *The Economy in the Reagan Years: The Economic Consequences of the Reagan Administrations* (Greenwood Press, 1994) 22-23.

²⁸ Donald D. Hester, "U.S. Banking in the Last Fifty Years," 12-14.

²⁹ Nancy L. Ross, "Changes Push Bankers Into 21st Century; Bankers Pushed Unwillingly Into 21st Century," *The Washington Post*, September 21, 1980 www.lexisnexis.com.

³⁰ M. Manfred Fabrituius and William Borges, 92.

By the election of 1980, the Carter administration was burdened by a multitude of problems: an energy crisis, stagflation, high interest rates, dropping labor productivity, the Soviet invasion of Afghanistan, and the Iranian hostage crisis. Many of the problems resulted from long-term global political and economic trends that spanned several of the previous decades. The post World War II economic system fell into crisis. The U.S. had gradually lost its position of economic dominance. It faced competition as post World War II Japan and Western Europe rebuilt their economies and Third World countries developed their manufacturing capacity. The rise in labor productivity abroad and the drop of labor productivity at home encouraged capital flight to other countries. This drained the domestic economy of much-needed investment capital, exacerbating the productivity problem. In addition, oil-producing countries in the Middle East asserted new independence and power over other countries that clamored for their resources and poured funds into their investments. The world had become more integrated and interdependent, and in the process, the U.S. global position had eroded. These broad developments came together in 1980 to create significant and decisive political change.³¹ Jimmy Carter lost the presidential election by 10 percentage points, and Republicans won 33 new seats in the House and took control of the Senate for the first time in 25 years. 1980 proved to be nothing short of a landslide election.³²

Political scientists Thomas Ferguson and Joel Rogers have argued that 1980 represented a realignment election, the culmination of a process in which business

³¹ Thomas Ferguson and Joel Rogers, "The Reagan Victory: Corporate Coalitions in the 1980 Campaign" in Thomas Ferguson and Joel Rogers, editors *The Hidden Election: Politics and Economics in the 1980 Presidential Campaign* (Pantheon Books, 1981) 9-26; Thomas Ferguson and Joel Rogers, *Right Turn: The Decline of the Democrats and the Future of American Politics* (Hill & Wang, 1986) 78-88.

³² Barbara Sinclair, "Agenda Control and Policy Success: Ronald Reagan and the 97th House," *Legislative Studies Quarterly*, X, 3 (August 1985), 292; Anthony S. Campagna, 23-27; Immanuel Wallerstein, "Friends as Foes," in Thomas Ferguson and Joel Rogers, editors, *The Political Economy: Readings in the Politics and Economics of American Public Policy* (M.E. Sharpe, Inc., 1984) 329-331.

interests reevaluated their positions and formed new political coalitions and party loyalties. Such realignments occur, they argue, “when cumulative long-run changes in industrial structures (commonly interacting with a variety of short-run factors, notably steep economic downturns) polarize the business community thus bringing together a new and powerful bloc of investors with durable interests.”³³ Ferguson and Rogers use the term “investors” to refer to those who contribute to or invest in political campaigns of parties and candidates who they believe will serve their interests once in office. Thus, they buy control of the political agenda and the environment in which they do business. Individuals, they argue, lack the information and resources to exert this kind of control over the U.S. political process and therefore, rarely get the chance to maximize their benefits. In Ferguson and Rogers’ view, politics are controlled mainly by business interests.³⁴

David Harvey expresses a similar view of this political watershed. He argues that the U.S. and the world faced a crisis in the mid 1970s as the economic and political systems that dominated the world after World War II fell apart both internationally and within countries. The economic crisis, which included high unemployment, high inflation, stagflation, increased demand for social spending, and the collapse of the Bretton Woods system challenged the political system in many countries. The old methods of controlling the economy—Keynesian spending, close government regulation of many industries, free trade, and fixed exchange rates—no longer appeared to work, and those to the left of the political spectrum failed to devise new and effective solutions, explains Harvey. Politics became more polarized with social democrats who believed in

³³ Thomas Ferguson, *Golden Rule: The Investment Theory of Party Competition and the Logic of Money-Driven Political Systems* (The University of Chicago Press, 1995) 22-25.

³⁴ *Ibid.*

government planning on one side and neo-liberals, who believed in “liberating individual entrepreneurial freedoms” on the other side. The neo-liberals won, and that victory, Harvey argues, was part of a political project to restore wealth and power to the elite class.³⁵

By 1980, almost all segments of U.S. business turned away from the Democratic Party, convinced that Republicans would more effectively pursue their interests. This meant that Reagan’s supporting coalition was a diverse group, with sometimes conflicting goals and preferences. For example, those with operations or investments abroad supported Reagan for his promise to strengthen the U.S. military and enhance U.S. power and prestige. They saw this promotion of stability as necessary protection for their investments.³⁶ Large banks, which had made loans to developing countries and collected deposits from wealthy oil-producing countries, fell into this group. Capitalists who depended on multi-national markets also desired stable and free trade and they too supported Reagan’s stance on increased military might and presence in foreign affairs. Corporate interests tied to military spending of course supported Reagan, as did the Sunbelt in general, which could only benefit from the infusion of federal military spending into their region. Ironically, domestic producers, with protectionist tendencies also joined the Republican coalition, attracted to the anti-labor, anti-regulatory platforms.

³⁵ David Harvey, *A Brief History of Neo-liberalism* (Oxford, 2005) 2-23.

³⁶ Jimmy Carter had bitterly disappointed capitalists with investments in Iran by proving unable to stabilize the Khomeini regime and protect U.S. interests there. Over the course of Reagan’s term, investment banks and insurance companies opposed his high deficit spending, which created expectations of inflation and hurt investor confidence in the bond market. See Ferguson and Rogers, *The Hidden Election*, 28-29, 154.

Domestic oil producers supported Reagan as well, looking for relief from government controls.³⁷ This coalition was indeed a broad one.

Political scientist Barbara Sinclair has argued that Reagan's early economic program reflected the fact that he had gained almost complete control of the national and Congressional political agendas through the Republican landslide election win. In 1981, she argues, Congress was so convinced of Reagan's public mandate for change, economic change in particular, that his administration could successfully secure passage of almost their entire program. In fact, their control of political alternatives proved so complete that even the Democrats, in an effort to win back the business investors they had lost in 1980, turned to the right, calling for similar initiatives.³⁸

Ferguson and Rogers argue that the varied interests and demands of Reagan's supporting coalition provided the context and limits for his policy decisions once in office. To balance many opposing interests, the administration pursued policies that either benefited all of Reagan's supporters, or helped some while acting neutrally towards others. Naomi Klein has recently argued that Reagan's election in 1980 represented a democratic implementation of neo-liberal policies. These policies are usually adopted in times of natural, military, or economic disaster, she explains. At such times of chaos and confusion, corporate interests, especially multinational corporate interests, seize the opportunity to quickly implement their vision, which they call free market capitalism. What they truly seek is "economic shock therapy," argues Klein, a sudden and complete adoption of "business friendly policy demands," such as privatization, deregulation, and

³⁷ Ferguson and Rogers, *Right Turn*, 88-93; Thomas Ferguson, *Golden Rule*, 243-245; Ferguson and Rogers, *The Hidden Election*, 18, 28-29; Mike Davis, *Prisoners of the American Dream: Politics and Economy in the History of the U.S. Working Class* (Verso, 1986) 171.

³⁸ Barbara Sinclair, "Agenda Control and Policy Success: Ronald Reagan and the 97th House" 291-314; Ferguson and Rogers, *Right Turn*, 138.

social spending cuts. They seek a pure form of capitalism. Corporate interests, backed by the Chicago School of Economics scholars who articulate their ideology, have been able to come close to full implementation in other countries. However, they did not have complete success in 1980 because they lacked a true disaster. In the case of democratic implementation of business friendly policies, resistance to economic shock therapy, to the complete transformation of the U.S. capitalist system, forced Reagan and his supporters to accept “piecemeal changes rather than a total conversion.”³⁹ Nonetheless, whether Reagan’s administration was trying to appease a large and varied set of business investors or attempting to transform the U.S. economy into a purer form of capitalism, they were very successful in pursuing business friendly policies.

Reagan’s initial program included a mix of fiscal policies designed to cut government spending on social programs while increasing defense spending, supply-side tax cuts, tight monetary policy to lower inflation, and decentralization of the economy through deregulation and the transfer of functions from the federal to state government. Led by David Stockman, the new Director of the Office of Budget Management, Reagan’s administration immediately launched cuts to social spending. The new budget lowered eligibility standards for programs such as student social security benefits and food stamps. It reduced welfare programs such as Medicaid, Aid to families with Dependent Children, and school lunch programs by \$5.5 billion. Subsidies to industries such as agriculture and energy were likewise reduced. Congress accepted most of these

³⁹ Naomi Klein, *The Shock Doctrine: The Rise of Disaster Capitalism* (New York: Henry Holt and Company, 2007) 6-12. Klein argues that the terrorist attack of September 11, 2001 later gave corporate interests a better opportunity to pursue their vision. The Bush administration immediately began waging a “war on terror,” in Iraq in which it vastly privatized functions formerly performed by the government such as health care and food services for soldier and prisoner interrogation. A huge international “disaster capitalism complex” formed, explains Klein. Those companies in the complex, providing private services, have profited enormously and seek to make the practice permanent.

proposed cuts, but strongly rejected Reagan's proposal to reduce Social Security benefits. The following September, the administration pushed for even more domestic spending cutbacks, but with less success.⁴⁰ These spending cuts, while clearly painful for poor Americans, did not affect most of Reagan's supporters.

The administration then guided the passage of the Economic Recovery and Tax Act of 1981, designed to stimulate economic growth through adjustments on the supply side. The act called for a three year program of comprehensive income tax cuts – 5% the first year, and 10% the second and third years. The bill also reduced the highest tax bracket from 70% to 50%, indexed tax rates to adjust for inflation, allowed charitable contributions to be deducted even if taxpayers did not itemize their returns, and deferred capital gains on the sale of primary residences if a new residence was purchased within two years. To encourage investment, the law also allowed for faster depreciation of capital assets. The most ardent supply-siders argued that these tax cuts would bring about such strong incentives to work and invest that they might finance themselves with quick results.⁴¹ However, that clearly proved to be an overstatement. What the tax modifications did accomplish was to contribute markedly to the growth of tax shelters for the wealthy. In fact, the overall program heaped the most benefits on the wealthiest 1% of the U.S. population. The ideology behind these supply-side adjustments was that the wealthy recipients of additional funds would either spend their windfall or invest it in useful ventures, creating stimuli for economic growth. In what became an infamous

⁴⁰ Michael J. Boskin, *Reagan and the Economy: The Successes, Failures, and Unfinished Agenda* (ICS Press, 1989) 52-62; Thomas Ferguson, *Right Turn*, 127-130; Robert Heilbroner and Aaron Singer, 323; Barbara Sinclair, 297.

⁴¹ In his memoirs, OMB Director, David Stockman, explains that Jude Wanniski and Art Laffer, "the two high priests of supply side, sometimes argued that the tax cuts would pay for themselves...I never bought that literally and didn't think they did, either. I put it down to salesmanship." See David A. Stockman, *The Triumph of Politics: How the Reagan Revolution Failed* (Harper & Row, 1986) 53.

phrase, the Reagan administration claimed that the benefits of this spending and investment would “trickle down” to lower income groups.⁴²

Reagan’s early monetary policy supported the Federal Reserve initiative to fight inflation by restricting the money supply that began under Carter. This meant that the recession and high interest rates would continue, making it difficult for the supply-side stimuli to work effectively. It also meant that unemployment rates would continue to be high for the rest of 1981 and 1982, hurting labor but perhaps helping Reagan’s supporters in labor-intensive domestic manufacturing industries.⁴³

Reagan’s deregulatory policy was, to some extent, a continuation of Carter’s efforts to cut unnecessary administrative costs and to revise inefficient rules that burdened industry and exacerbated inflation by raising prices. However, deregulation also had great ideological appeal to Reagan and his free market conservative constituency, who believed that government should play a much smaller role in private affairs. In addition, it allowed him to help some members of his coalition who sought relief from antitrust, environmental, labor, and other regulations. Once in office, Reagan created a Task Force on Regulatory Reform, chaired by Vice President George Bush, to study deregulatory issues. In the meantime, the administration found ways to cut regulation without legislative efforts. For example, he gave OMB the power to review and oversee regulatory changes, requiring the individual agencies to prepare a Regulatory Impact Analysis for each new regulation. The OMB, with its clear bias towards lowering spending, then performed its version of cost-benefit analysis on the proposed changes. Reagan also tended to appoint agency heads who shared his deregulatory philosophies,

⁴² *Ibid.*

⁴³ Anthony Campagna, 33-34; Michael J. Boskin, 63-64.

people who would certainly avoid establishing new regulations, and in some cases, people who were somewhat unsupportive of the agencies they led. For example, his appointments to the Department of Labor, OSHA, and the National Labor Relations Board were all somewhat unsupportive of unions. He likewise tended to dismiss those staff members who proved unsympathetic to his deregulatory cause.⁴⁴ Besides helping domestic producers through deregulation, the Reagan administration tended to meet their needs and demands through individual actions and favors on a per industry basis that allowed for the provision of aid while maintaining an open trade policy.⁴⁵

The recession and high interest rates that accompanied Reagan's early economic program caused continuing problems for the savings and loan industry. Even though DIDMCA had taken steps to help the industry, those solutions had not yet had a chance to work. In fact, in the short run, these changes may have hurt more than they helped because deregulation of interest rates meant that S&Ls now had to pay more for their funds. From 1980-1982, the average cost of fund for thrifts was rising faster than the return on assets.⁴⁶ Furthermore, even as depository institutions increased rates on deposits, unregulated money market funds continued to drain money away from them, offering rates as high as 16% in March of 1981.⁴⁷ In many cases, consumers could earn up to 10% more on their savings in money market funds.⁴⁸ On the lending side, thrifts did not immediately take advantage of the powers granted by DIDMCA because it took a

⁴⁴ Anthony S. Campagna, 98-100, Michael J. Boskin, 63-4; Thomas Ferguson, *Right Turn*, 130-133.

⁴⁵ Thomas Ferguson, *Golden Rule*, 246.

⁴⁶ R. Dan Brumbaugh, Jr., *Thrifts Under Siege: Restoring Order to American Banking* (Ballinger Publishing Company, 1988) 30-35; The economy contracted 1.5% in 1982. See David Stockman 98-99.

⁴⁷ "Clyde H. Farnsworth, "Aid Studied for Savings Industry" *The New York Times*, March 6, 1981 Late City Final Addition, p.1 ProQuest Historical Newspapers The New York Times (1851 - 2005).

⁴⁸ Thomas P. Vartanian, "Remarks Regarding the Depository Institutions Act of 1982" November 17, 1982 in Harold E. Mortimer, Chairman, and L. Richard Fischer and Russell A. Freeman, Co-Chairmen, *The Depository Institutions Act of 1982* (Practicing Law Institute, 1983) 16-17.

while to research, plan for, and execute these programs. New lending on mortgages dropped, as unemployment and high interest rates made it more difficult for Americans to buy homes. Problems faced by the industry proved numerous and challenging.⁴⁹

The Reagan administration's handling of the industry's problems was deeply influenced by three factors: the need to balance the interests of Reagan's broad political coalition, the determination to keep any potential solutions off the federal budget, and a deep commitment to minimize government interference with business. Ideologically, Reagan's administration had little interest in helping the thrift industry. The stance that government should not interfere in most industries dictated that ailing institutions should either merge with stronger institutions, or be allowed to die. Furthermore, Reagan's goal to cut non-military domestic spending became an obstacle to the implementation of sound solutions that would have ultimately minimized taxpayer liability. The administration, however, could not be guided solely by its anti-spending and small government preferences because many savings and loan executives were important investors in Reagan's political coalition. When he took office, 9 of the nation's 10 largest S&Ls were located in Reagan's home state of California and were headed by Republican executives, many of whom contributed to the 1980 campaign. Reagan's reliance on political contributions and support from this group limited the spectrum of options available to **him** and his administration.⁵⁰

⁴⁹ David Mason, 218.

⁵⁰ Kathleen Day, *S&L Hell: The People and Politics Behind the \$1 Trillion Savings and Loan Scandal* (W. Norton & Company, 1993) 76-90; Campaign contributions are very difficult to trace. According to Lenny Glynn, savings and loans contributed approximately \$11 million to politicians during the 1980s. Lenny Glynn, "Who Really Made the S&L Mess" in Robert Emmet Long, editor, *Banking Scandals: The S&Ls and BCCI* (The H.W. Wilson Company, 1993).

The crafting of savings and loan policy proved complex during the early 1980s and was shaped by multiple opposing forces and participants including Congress, regulators, the industry, and the Reagan administration. The S&L industry, of course, wanted government aid. In their view, they suffered from a problem not of their own making. They had done what the government had asked of them since the New Deal – provided fixed-rate, long term, and reasonably priced home loans. Yet, high interest rates and inflation threatened net worth, profitability, and in some cases solvency. Among other things, the industry wanted access to cheaper capital in order to shrink the spread between rates they paid for funds and interest they collected from past loans. Some in the industry also wanted relief from the particularly challenging business environment, perhaps through a government purchase of old, low-yielding mortgages. The largest of the S&Ls, represented mainly by the National Savings and Loan League, strongly favored deregulation, and understood that their institutions needed to change radically if they were to survive. The S&L industry engaged in an enormous amount of lobbying and had many friends in Congress, including the head of the House banking committee, Democrat, Ferdinand St. Germain, and Senate banking committee member, Democrat, Alan Cranston. While many members of Congress supported the industry because they were the recipients of S&L largesse, others did so because they truly understood the seriousness of the industry's condition and found the cause of home financing popular with their constituents. In addition, Chairman of the Senate banking committee, Republican, Jake Garn has been described by journalist Kathleen Day as “a darling of the Reagan-Bush White House,” though Day also depicts him as a friend of the S&L

industry. Like the Reagan administration, Jake Garn claimed to believe in free market solutions.⁵¹

Despite the campaign support many S&L executives provided to Ronald Reagan, the administration opposed any kind of bailout or government assistance to the industry that would appear on the budget. This was especially true of Secretary of the Treasury Donald Regan,⁵² and Assistant Treasury Secretary Roger Mehle. Reagan had put Mehle in charge of S&L policy. In addition, David Stockman, director of the OMB opposed government aid to any industry that would interfere with spending cuts to which he was deeply committed. This trio initially opposed most solutions to provide aid to the industry and Regan and Mehle, in particular, were viewed as enemies of the industry. However, they had to tread carefully since alienating part of Reagan's supportive coalition would have been problematic.⁵³

Richard Pratt, a Republican nominated by Reagan as Chairman of the Federal Home Loan Bank Board in March of 1981, became somewhat of a bridge, joining together the various disparate interests. A University of Utah business professor, Pratt had extensive experience in the savings and loan industry. He had worked as chief economist for the U.S. League during the late 1960s and had also been a consultant for the California S&L League. From 1970-1979, he was director of the Seattle Federal Home Loan Bank. Pratt was clearly an industry insider, chosen by the U.S. League,

⁵¹ Rudolph A. Pyatt, Jr., "S&Ls, Facing Greater Competition, Score Regulatory Agency; Thrift Leaders Assail Regan on S&L Regulation" *The Washington Post*, October 19, 1981 www.lexisnexis.com. Robert G. Kaiser, "Behind the Saving of America's Savings and Loans; Political Chronicle of the Salvation of America's Savings and Loans; High Interest Rates Are the Villain for S&Ls" *The Washington Post*, July 5, 1981, p. A1 www.lexisnexis.com; Kathleen Day, 76-90.

⁵² Regan was a former Meryl Lynch chief executive who strongly believed that S&Ls needed freedom from regulation, especially regulations regarding brokered deposits. See L William Seidman, *Full Faith and Credit: the Great S&L Debacle and Other Washington Sagas* (Times Books, 1993) 181-182.

⁵³ Kathleen Day, 76-90.

which had considerable influence over the filling of this position.⁵⁴ However, Pratt's connections did not end there. Pratt was also a protégé of the aforementioned chair of the Senate Banking committee, Jake Garn, which connected Pratt to the Reagan administration as well. Both Pratt and Garn were Republicans from Utah, and both were Mormons. Richard Pratt would be the architect, charged with drafting all aspects of the intricate S&L solution. Pratt hired Thomas Vartanian as head counsel of the Federal Home Loan Bank Board and Brent Beesley, a fellow Mormon from Utah, as the head of the Federal Savings and Loan Insurance Corporation.⁵⁵ This team of men, connected to each other, the S&L industry, and the White House became the tight-rope walkers in charge of devising a plan that would please Reagan's supporters in the industry, avoid alienating other groups in the Reagan coalition, remain consistent with Reagan administration spending targets, and meet with Congressional approval – a complex balancing act to say the least.

Those working on a course of action for S&Ls understood the critical nature of the industry's condition. At the beginning of 1981, Alan Greenspan argued that 9 out of 10 thrifts were losing money. By the end of that year, Pratt informed Federal Reserve Chair Paul Volcker, that the magnitude of the industry's problems amounted to about \$100 billion. Pratt knew he had to act decisively, but he also knew that the White House and the industry wanted him to avoid publicizing the miserable financial condition of many S&Ls.⁵⁶ He was to devise a quiet solution that avoided the costly alternative of shutting down institutions. For Pratt, and the Reagan administration, who already

⁵⁴Kathleen Day, 83-85; "Home Loan Bank Choice" *New York Times* Mar 20, 1981 p.D8 ProQuest Historical Newspapers The New York Times (1851 - 2005).
⁵⁵Kathleen Day, 83-86; L. William Seidman, *Full Faith and Credit: the Great S&L Debacle and Other Washington Sagas* (Times Books, 1993) 181-182.
⁵⁶ Kathleen Day, 74, 93.

believed in reducing government hindrance or interference with business, deregulation emerged as the obvious answer.⁵⁷ Deregulation would provide benefits to the industry without costing the government anything or clashing with the administration's ideology.

Speaking to a group of attorneys in 1982, Thomas Vartanian recalled that

there were only a limited number of practical actions that could be taken to ease the strain: increased deregulation of regulated financial institutions, a new system of regulation imposed upon non-depository institutions such as money market mutual funds, and/or immediate strengthening of the financial regulators to ensure that the weak competitors which would not be able to survive would be allowed to fail in a non-disruptive fashion with as little cost to the FSLIC and the FDIC as possible. A new trend was now clearly visible on the horizon.⁵⁸

Clearly absent from Vartanian's list of options were viable alternatives such as shutting down troubled institutions before they created greater exposure to the insurance fund.

Also not considered was a mortgage warehousing plan proposed by Senator Moynihan of New York in which the government would purchase and hold mortgages owned by banks and S&Ls that paid less than a given interest rate. When short term rates dropped down to a certain level, the institutions would be allowed to buy them back. Thus, the government would take the loss associated with the interest rate differential and the depository institutions, freed from their poorly performing past assets, could write new profitable mortgages. At the time, the program would have cost about \$10 billion.

Though the U.S. Savings League gave its heavy support, the Treasury department violently opposed the proposition, because of the cost it would put on the budget, referring to it as a "hidden subsidy."⁵⁹ The Bank Board obviously never pushed for this

⁵⁷ Martin Mayer, 60.

⁵⁸ Thomas P. Vartanian, "Remarks Regarding the Depository Institutions Act of 1982," 18.

⁵⁹ Martin Lowy, *High Rollers: Inside the Savings and Loan Debacle* (Praeger, 1991) 21.

or other options that would put expenses on the budget. Vartanian recalled the clear decision to deregulate as much as possible:

Regulated institutions would need the freedom to choose the type of business they wanted, given their own abilities, competitive environments and economic motivations. Therefore, the FHLBB decided to remove itself from managerial, decision-making processes to the extent legally permissible.⁶⁰

While some of the deregulatory program would require Congressional approval, as chief S&L regulator, Pratt and his bank board could accomplish much of it on their own. For example, the first action Pratt took was to issue a regulation allowing S&Ls throughout the nation to write adjustable rate mortgages (ARMs) in April of 1981. Prior to this time, S&Ls could only offer ARMs in states that allowed their state institutions to write such loans. This was probably much needed as it served as the only means for institutions to protect themselves from interest rate volatility. Furthermore, Pratt's board permitted S&Ls to engage in futures and options markets. Also in 1981, Pratt changed the rules regarding S&L ownership and deposit insurance. Up until that time, in order to qualify for deposit insurance, a stockholder-owned S&L had to have at least 400 shareholders, 125 of them from the community served. Regulations also prohibited any one person from owning more than 10% of the S&L's stock and any control group from owning more than 25% of the stock. Pratt's board eliminated these requirements, allowing a thrift owned by just one person to obtain deposit insurance. In addition, that one owner could receive 100% financing for the purchase from the Federal Home Loan bank, putting up real estate as security. Thus, the owner would have very little of his or her own capital invested in the thrift. Pratt also changed restrictions on the brokered deposits that S&Ls collected. Before 1981, S&Ls could collect only 5% of their total

⁶⁰ Ibid., 19.

deposits from brokers. The rest came from individual consumers. Brokered funds were traditionally viewed as supplementary because they were more expensive than consumer deposits, and they tended to move rapidly from institution to institution in search of the highest going interest rate. S&Ls tended to turn to brokered funds only periodically when mortgage demand exceeded available capital. Pratt eliminated the restriction completely, allowing S&Ls to obtain as much as they pleased in brokered deposits.⁶¹

Perhaps the biggest regulatory change during Pratt's tenure occurred in January of 1982 when the FHLBB allowed thrifts to switch accounting methods for financial statements to regulators from Generally Accepted Accounting Procedures (GAAP) to Regulatory Accounting Procedures (RAP). As the industry sank into deeper financial distress, RAP helped S&Ls to appear healthier than they really were in a number of ways. In terms of assets, under RAP thrifts could revalue properties they owned from foreclosures, direct investments, or their own office buildings at market value when calculating net worth. Of course, appraisers determined market values in a subjective process that often resulted in inflated values, which caused assets to seem larger than they really were. RAP also allowed thrifts to spread losses over ten years, while under GAAP losses *had* to be taken immediately in the year incurred. Finally, RAP treated Goodwill *generated* from mergers differently from GAAP. While GAAP allowed Goodwill to *remain as an* asset on the balance sheet for 10 years, RAP lengthened that period to 40 years. *Although* Goodwill often represented a legitimate asset – a certain intangible *value derived* from the merger- the 40 year rule seemed to exceed reasonable limits. For

⁶¹ R. Dan Brumbaugh, Jr., *Thrifts Under Siege*, 42,150; R. Dan Brumbaugh, Jr., *The Collapse of Federally Insured Depositories: The Savings and Loans as Precursor*, (Garland Publishing, Inc., 1993) 34-40; Martin Mayer, 63-65. David Mason 220-221; Thomas P. Vartanian, "Remarks Regarding the Depository Institutions Act of 1982," 19-24.

example, the Securities and Exchange Commission ruled that publicly traded savings and loans could only claim goodwill as an asset for 25 years.⁶² Using the change in Goodwill accounting rules as an incentive, the FHLBB encouraged and sometimes even arranged for mergers of weak institutions. This enabled them to quietly solve the problem without burdening FSLIC or the federal government with any costs. Thus, the FHLBB saw the merger of 516 S&Ls between 1980 and 1982.⁶³

The new rules about losses dramatically affected the S&L industry. Beginning in September 1981 and expanding in May 1982, the FHLBB encouraged troubled thrifts to sell their low-yielding mortgages, written at lower rates of the past. Then, for tax purposes, they were permitted to write off the entire loss during one year, resulting in a tax credit. Of course, for regulatory accounting purposes, institutions spread that same loss over the life of the loan.⁶⁴ Again, this policy served as a way to funnel some money into thrifts in the form of a tax credit, without having to put new expenses on the federal budget or drain money from FSLIC. At the same time, it made troubled S&Ls appear healthier than they were.

While some of these regulatory reforms made legitimately needed changes, most *merely placed* a band-aid on a wound that demanded more serious treatment. Worse yet, *some of the* changes, like the switch to RAP, covered the wound so that nobody could see *the bleeding*. But Pratt's options were limited by political considerations. The Reagan *Administration* would never have supported the appropriation of billions of dollars *needed to make* a legitimate attempt at solving the problem.

⁶² David Mason, 220-223; Martin Mayer 70; R. Dan Brumbaugh, Jr., *Thrifts Under Siege*, 60-62.
⁶³ David Mason 221-223; Martin Mayer, 65-8.
⁶⁴ Martin Mayer, 70-71.

t

S

A

H

t

M

a

(

S

I

a

a

C

Y

t

r

d

f

S

S

S

>

55

F

56

In the meantime, Richard Pratt also pursued deregulation and aid for the industry through legislative channels. Pratt and his staff ultimately designed and wrote the Garn-St. Germain Act of 1982, with full support and participation from the Reagan Administration. Early drafts of the bill were even referred to as “the Pratt bill.” However, Pratt had to balance many interests in accomplishing this legislative feat, not the least of which was an apparent lack of support from Treasury officials Regan and Mehle early in the process. In the spring of 1981, Pratt, as Chairman of the FHLBB, along with regulators from the FDIC, the Fed, and the NCUA approached Fernand St. Germain, the Chairman of the House banking committee, asking him, “to consider statutory changes to broaden their merger and acquisition authorities, and to expand the resources of the Federal deposit insurance funds.”⁶⁵ St. Germain, reported receiving a fair amount of support and cooperation from the House and Senate for a bill that would accomplish such changes, but “inflammatory statements by high-ranking administration officials culminated in a Treasury Department veto.”⁶⁶ It would seem that Pratt had not yet secured Regan and Mehle’s support for his legislative agenda.

A few months later, at a House banking committee hearing, Pratt and Mehle both testified as to the condition of the savings and loan industry, the need for emergency relief, and the best path to pursue in helping the industry. The testimony of the two men differed significantly with respect to the immediate condition of the industry and the need for emergency measures to improve the situation. Pratt, who came across as highly sympathetic to the plight of thrifts argued that “the industry is structurally unsuited to survive under the present set of economic circumstances and competitive interfaces.”

⁶⁵ House Committee on Banking, Finance, and Urban Affairs, *Conduct of Monetary Policy (Pursuant to the Full Employment and Balanced Growth Act of 1978)*, 97th Congress, 1st session, July 14, 1981, 1.

⁶⁶ *Ibid.*, 2.

Furthermore, he claimed, Congress created the untenable environment for thrifts by expecting them to pay market rates of interest on liabilities, while restricting their ability to earn competitive rates of return on assets. Such inequality among depository institutions, he complained, “will guarantee the lack of thrift survivability and the lack of home finance money in this country.”⁶⁷ Besides calling for structural change, Pratt insisted that FSLIC needed additional flexibility in handling troubled thrifts. He, and the other regulators of depository institutions, also emphasized the urgent and immediate need for his program. “...as a means of crisis management,” he argued, “we believe it is vital that the Congress provide the FSLIC with certain tools.” He also warned that “If Congress does not act in the short run to address this matter, there will be no long run for a very substantial segment of the thrift industry.”⁶⁸

The testimony of Assistant Secretary of the Treasury Roger Mehle proved far less alarmist. Mehle clearly acknowledged the difficulties and challenges that inflation, high interest rates, and competition from money market mutual funds inflicted on thrifts. These problems required attention, he admitted. However, he felt that the best solution involved long-term reform, in particular deregulation of restrictions on assets, and the improvement of economic conditions. “What the industry needs at the moment, along with the entire economy, is less inflation and lower short-term interest rates,” Mehle told the House banking committee. This would be accomplished, he argued, through Reagan’s newly implemented economic program. He did not believe that the problem called for emergent action or legislation. To the contrary, he communicated that “[w]e believe the Federal deposit insurance agencies and other regulators with whom we have

⁶⁷ Ibid., 35.

⁶⁸ Ibid., 36.

be

ins

M

the

M

qu

"T

th

pr

w

D

ar

di

Te

co

co

—

99

70

71

1

been in close contact can deal adequately with any seriously troubled depository institutions that need special assistance before short term interest rates decline.” Thus, Mehle was no more supportive of what had come to be known as the “regulators’ bill” than he had been the previous spring when the Treasury Department vetoed the effort.⁶⁹

Some members of the House banking committee seemed to take offense to Mehle’s nonchalant attitude about the condition of thrifts. For example, during the question session, Representative Stanton, a fellow Republican from Ohio, asked Mehle, “Does the administration plan to abandon the financial savings and loan industry, or will they help them? They [the savings and loan industry] are convinced that they have a problem. Moreover, they are convinced that you don’t think they have a problem. That would be underscored by your statement here this morning.”⁷⁰ Representative LaFalce, a Democrat from New York, certainly noticed the discrepancy between Mehle’s testimony and that of Pratt and other regulators:

We’re getting dire reports from the regulators, and you’re coming before us as a representative of the administration; and you are painting the other side of the coin. You’re saying, well, the glass is half full; the others have said it’s half empty. As a matter of fact, they have said more than, it’s half empty; they have said it’s like about 90-percent empty. So we’ve got not only a difference in nuance or perspective, but perhaps in factual interpretation.⁷¹

Weeks later, this difference of opinion between Pratt and Mehle was still sparking discussion among banking committee members. Henry Gonzalez, a Democrat from Texas, sent a letter to St. Germain, expressing that at the hearing “a strange, contradictory, and ominous, series of events occurred. Mehle’s testimony flatly contradicted the previous testimony presented by Chairman Pratt and two other

⁶⁹ Ibid., 439.

⁷⁰ Ibid., 450.

⁷¹ Ibid., 458.

regulators.” Gonzalez went on to explain that “Mehle categorically denied any emergency and made, what to me, are astounding dogmatic pronunciamientos of ‘no crisis.’ Both of these men cannot be correct.”⁷² St. Germain responded to Gonzalez affirming that “I share your concerns that this divergence of views have great implications for public policy and for our financial markets.” He told Gonzalez that he introduced the Regulators’ bill again on July 30, explaining that “Clearly the Administration precluded action on the bill before the recess and again clouds the outlook for such legislation.”⁷³

However, the two men may have been exaggerating the differences between Pratt and Mehle. While the tone of Pratt’s testimony differed markedly from Mehle’s, the substance did not diverge quite as much as Gonzalez and St. Germain claimed. Pratt argued that the crisis suffered by thrifts called for three different policy initiatives. First, he contended, “the efforts of the administration and of the Federal Reserve to bring inflation under control must be allowed to work.” Next, he highlighted the need for Congress to grant regulators the power to use additional tools “as a means of crisis management.” Third, Congress needed to deregulate the asset side of thrift balance sheets, allowing them to diversify their portfolios and rely less heavily on the mortgage market.⁷⁴ While Mehle clearly disagreed with Pratt’s assertion that regulators needed special tools to deal with the current crisis, he did not disagree with Pratt’s other two premises. Furthermore, with regard to the special tools that Pratt asked for, otherwise known as the “Regulators’ bill,” Mehle claimed that “Two of the parts, the administration

⁷² *Depository Insurance Flexibility*, Act 97th Congress, 1st session, *Congressional Record* 127 (October 27, 1981): 25410.

⁷³ *Ibid.*, 25411.

⁷⁴ House Committee on Banking, Finance, and Urban Affairs, *Conduct of Monetary Policy (Pursuant to the Full Employment and Balanced Growth Act of 1978)*, 97th Congress, 1st session, July 14, 1981, 36.

did not favor; one of the parts the administration was unopposed to—was sympathetic to in fact.” Mehle and the administration opposed increasing the regulators’ borrowing lines with the Treasury and the expansion of capital assistance powers. However, he and the administration were supportive of a provision that would give regulators the power to set up interstate and inter-industry mergers for ailing thrifts and said that they had already communicated that support to the House and Senate banking committees.⁷⁵ This is consistent with letters sent to St. Germain by Secretary Treasury Regan, stating that:

the Administration believes the President’s economic program is the best remedy for the current ills of mutual savings banks and savings and loan associations ...Over the longer term, I will be urging the regulatory agencies and Congress to liberalize the asset powers of thrift institutions to make these organizations more competitive in every type of economic environment.⁷⁶

In a later letter, he said “The Administration has no objection to the regulators’ proposals for interstate and inter-industry mergers and consolidations. We are sympathetic to what appears to be a competitive free market means of dealing with a failing depository institution.”⁷⁷ Therefore, in reality, Pratt and the Treasury only strongly disagreed about how to handle the immediate, short-term thrift crisis, not over the proper long-term course of action. The Treasury Department seemingly objected to any resolution of thrift industry problems that would appear as an expense on the budget. Solutions that would not cost anything, such as deregulation and mergers got full administration support.

Despite the Treasury’s objections, the House banking committee reported the “Regulators’ bill” on October 7, 1981 to the House. Gonzalez had urged St. Germain to

⁷⁵ Ibid., 450.

⁷⁶ *Deposit Insurance Flexibility Act*, H.R. 4603, 97th Congress, 1st session, *Congressional Record* 127 (October 27, 1981): 25407-25423.

⁷⁷ Ibid.

move ahead on the bill notwithstanding the administration's opposition, "I believe that Congress has to respond and take action immediately otherwise, once again, we will be the patsy for the Reagan Administration ploys against the Democrats."⁷⁸ On the same date, Republican, William Stanton introduced the Thrift Institutions Restructuring Act, which proposed giving savings and loans greatly expanded asset powers. In introducing the bill, Stanton gave his full support to passage of the Regulators' bill, but emphasized that a more long-term solution was necessary as well. Stanton said he was introducing the bill "at the request of Chairman Richard T. Pratt, of the Federal Home Loan Bank Board, [and] on behalf of the administration, which has endorsed it."⁷⁹ Also on the same date, Jake Garn, Republican Chairman of the Senate banking committee introduced S. 1720, a more far-reaching bill that not only expanded asset powers of thrifts, but also increased deposit insurance to \$250,000 for IRA and Keough retirement accounts, allowed credit unions to offer a broader range of real-estate loans, permitted commercial banks to underwrite municipal revenue bonds, allowed all depository institutions to manage and sell mutual fund investments, and preempted state usury ceilings on consumer loans. Garn commented that much of the bill had been drafted by the regulators themselves, such as Pratt.⁸⁰

The House, which enjoyed a Democratic majority, passed the Regulators' bill on October 28, 1981, but the Republican-dominated Senate did not act on it. On February 23, 1982, St. Germain tried again, introducing a bill that would create the Home Mortgage Capital Stability Fund. This law would appropriate a \$7.5 billion fund that

⁷⁸ Ibid.

⁷⁹ *The Plight of Thrift Institutions*, H.R. 4603, 97th Congress, 1st session, *Congressional Record* 127 (October 7, 1981): 23726-23728.

⁸⁰ *S. 1720*, 97th Congress, 1st session, *Congressional Record* 127 (October 7, 1981): 23616.

regulators from the FHLBB, FDIC, and NCUA could draw on to assist troubled mortgage-lending institutions whose net worth dropped below 2% of assets. The aided institutions would have to pay back the funds with interest and would be required to earmark 50% of new deposits for mortgage loans on 1-4 family residences.⁸¹

On May 4, after committee hearings, St. Germain introduced a revised version of the bill. The revisions, he explained, responded to “concerns raised by the witnesses and to concerns over the budget impact of the original bill.” Instead of directly loaning funds to ailing thrifts with net worth problems, the federal government would guarantee the net worth of federally or state-insured institutions. The guarantee would be backed by an \$8.5 billion account in the Treasury, but the government would only have to pay out cash if the guaranteed institution failed and was liquidated.⁸² St. Germain seemed to finally accept that the Reagan administration would only go along with a plan that refrained from placing expenses on the budget. The House passed the revised bill on May 20, 1982, with St. Germain claiming it was supported by the U.S. League, the Independent Bankers Association, the National Associations of Mutual Savings Banks, and the Consumer Coalition. The ranking Republican member of the banking committee, Chalmers Wylie offered a substitute amendment that differed from St. Germain’s bill in two ways. First, it did not offer net worth assistance to banks along with thrifts. The bill need not contain “anything for commercial banks because commercial banking is not a troubled industry at the present time,” argued Wylie. Secondly, it addressed net worth shortages by having troubled thrifts issue income capital certificates in exchange for

⁸¹ Home Mortgage Capital Stability Fund, 97th Congress, 2nd session, *Congressional Record* 128 (February 23, 1982).

⁸² *Net Worth Guarantee Act*, 97th Congress, 2nd session, *Congressional Record* 128 (May 4, 1982): 8655-56.

promissory notes, which he claimed would by accounting standards, actually boost net worth. Wylie claimed that accounting authorities did not believe that St. Germain's net worth guarantee by the Federal government would technically boost net worth. He also argued that St. Germain's method would take longer since an appropriation would have to be made for the Treasury fund backing the guarantee.⁸³ St. Germain's version passed in the House that day, but the key work on this bill was done in the Republican-dominated Senate.

The House bill, which contained only short-term relief provisions for the industry proved to be a skeleton compared to the Senate version, which its banking committee worked on for 18 months. Like the House bill, the Senate version provided regulators with expanded powers to help troubled thrifts and credit unions, all of which were subject to sunset in three years. In addition to permitting the assumption of liabilities, contributions, and the purchase of securities by regulatory agencies, the bill formally allowed regulators to arrange mergers for ailing institutions. This was already taking place,⁸⁴ but the bill sought to control the process by providing a hierarchy of preferences, privileging in-state mergers over interstate ones and mergers of similar institutions over dissimilar ones. It also provided that regulators give priority to institutions in adjacent states over ones farther away. As Alan Cranston commented during debate on the bill, "the restraints in this section are meant to discourage the use of involuntary mergers as the primary solution to the thrift crisis. Indeed it is the intent of the Congress that all

⁸³ *Providing For consideration of HR 6267, Net Worth Guarantee Act*, H.R. 6267, 97th Congress, 2nd session, *Congressional Record* 128 (May 20, 1982): 10760-10766.

⁸⁴ Traditionally the FHLBB followed laws that applied to commercial banks even though they were not obligated to do so, and federal law did not permit commercial banks to branch across state lines without the permission of the state into which they were crossing. Pratt chose to stop following that guideline when it came to troubled savings and loans and thus made it easier to arrange mergers. He also chose to stop following the federal law that forbade non banking corporations from owning banks for the same reason. See Kathleen Day, 95.

other options and alternatives be considered and that a true emergency exist before this section is used.” Some in Congress feared that use of interstate, inter-industry mergers to solve the problems of distressed institutions would erode interstate branching restrictions set up by the McFadden Act in 1927. Regional competition and concentration of power lay at the heart of this debate. As James Exon, a Democrat from Nebraska argued, “Through the proliferation of our financial institutions we have been contributing to taking the money out of the communities and transferring that money to large financial centers and, with it, considerable economic power.” The bill provided for other emergency relief provisions, including allowing the FDIC to facilitate an institution’s conversion to a stock association in order to raise funds and allowing the FHLBB to appoint FSLIC sole conservator of a state institution under emergency conditions even if prohibited by state law.⁸⁵

The Senate bill also created a capital assistance program for thrifts with net worth problems, permitting the FDIC and FSLIC to purchase capital certificates from troubled institutions, thereby raising net worth. To qualify for the program, institutions had to have a net worth of 3% of assets or less, have suffered a loss during the last two consecutive quarters, have the ability to remain solvent for at least 6 more months, and have at least 20% of assets invested in mortgages or mortgage-backed securities. The bill also greatly expanded the lending options available to thrifts, pre-empted state restrictions on the enforcement of due-on-sale clauses, provided that within 60 days of the law’s passage, DIDC create an account equivalent to and competitive with money market mutual funds. The minimum deposit for such accounts was to be no more than

⁸⁵ *Depository Institutions Amendments of 1982*, S. 2879, 97th Congress, 2nd session, *Congressional Record* 128 (September 24, 1982): 25123-25163.

\$5,000 and there were to be no interest rate ceilings. Furthermore, the law instructed DIDC that all accounts were to be freed of rate ceilings and the differential by January 1, 1984.⁸⁶

As the Senate discussed the bill and as various Senators proposed amendments, Jake Garn spoke to the difficulties encountered in reaching a consensus among all interested parties:

A year and a half of working on this bill has produced a very fragile coalition of those who would agree on it. In fact, we reached a point a lot of people thought was never possible, as controversial as some of the issues were, such as due on sale, new powers for the thrifts, and many other issues. At this point, the ice is so thin, I believe that unless we can keep the bill as reported by the committee intact we would probably lose it and not be able to enact it this year... I will oppose any and all amendments today for the same reason.⁸⁷

The bill passed the Senate on September 24, 1982 without any major amendments. Ultimately, it went to conference to reconcile the vastly different House and Senate versions. Why were the two bills so different? Both houses of Congress exhibited a desire to help thrifts weather the crisis and retool for the future. However, the Republican-dominated Senate proved much more willing to push through Pratt's entire reform agenda quickly. The Democratic-controlled House was far more hesitant. Part of the answer may involve Pratt's and the Reagan administration's close relationship with Senate banking committee chairman Jake Garn. Garn could facilitate the process for Pratt in the Senate. The House effort was a bit messier, as Democrats fought back against the administration's program. As detailed above, St. Germain tried fruitlessly to appropriate on-budget funds to the industry, which the Reagan administration simply refused to support. The House also attempted to split short-term thrift aid from long-term

⁸⁶ Ibid.

⁸⁷ Ibid., 25132.

deregulatory issues, which the administration also opposed.⁸⁸ In fact, when the bills were formally separated, Donald Regan withdrew the Treasury's request to testify before the House banking committee, stating "The Department would prefer not to address this bill in isolation of the other issues affecting the thrift industry. Therefore, we would like to refrain from testifying until your committee begins comprehensive hearings on financial institutions..."⁸⁹ In the end, Pratt and the administration got all they wanted. Virtually all the provisions agreed upon in the Senate were approved in conference.⁹⁰

As one might imagine, not everyone in the House was pleased with the resulting bill or with the process by which it was pushed through. The conference report was presented to the House during the closing hours of the end of the session, under a rule that prohibited separate voting on the individual provisions. Representatives were faced with a take-it-all or leave-it-all decision, so in order to provide emergency relief to the industry, they also had to agree to deregulation. On the other hand, Republican Trent Lott was correct in pointing out that "these are not new issues. They have been debated before Congress for decades. The difference is that now there is a need as there has never been before." Also, supporters argued that the bill had widespread support from most of the interested parties. Stanton claimed that of the 40,000 financial institutions in the country, about 38,500 supported the legislation. St. Germain claimed it was supported by the Fed, the FDIC, the FHLBB, the Comptroller of the Currency, the Department of the

⁸⁸ Richard Pratt and the administration clearly wanted their entire program to become law during the 97th session of Congress. As mentioned above, upon introducing the Thrift Institutions Restructuring Act, which dealt with longer-term regulatory change, House Republican William Stanton said he did so on behalf of Richard Pratt and the administration.

⁸⁹ *Providing for the consideration of H.R. 4603, Deposit Insurance Flexibility Act*, H.R. 4603, 97th Congress, 1st session, *Congressional Record* 127 (October 27, 1981): 25407-25411.

⁹⁰ *Conference Report on H.R. 6267 Net Worth Guarantee Act*, H.R. 6267, 97th Congress, 2nd session, *Congressional Record* 128 (September 30, 1984) 26426.

Treasury, the NCUA, and “every trade group affected except the Independent Bankers Association.”

The independent bankers objected to the new lending powers the bill bestowed upon thrifts and to the deposit instrument created to compete with unregulated money market mutual funds. In fact, small independent banks, designed to service only their local communities, had suffered for quite some time under the increased competition created by money market mutual funds and by DIDMCA’s deregulation, which allowed thrifts to enjoy some of the same asset powers as banks. At the 1981 Annual Convention of the American Bankers Association, the president of a small Arkansas bank told the audience that small banks “feel like a country dog that’s brought to the city. We don’t know who our friends are and we’re getting kicked from both sides.”⁹¹

Money market funds hurt small banks just as they hurt S&Ls: by causing disintermediation. Depositors increasingly moved their savings to the funds, which offered as much as 10% more interest than banks or S&Ls could offer under Regulation Q limits. However, deregulation of rate limits also hurt bank profitability as it created the same kind of interest rate squeeze experienced by thrifts. It became difficult for small banks to be profitable when they had to pay such high rates on their funds. Banks of all sizes responded to the new conditions by raising their fees for deposit services, reducing branch operating costs, and shifting to assets that produced higher earnings.

Notwithstanding these attempts to boost earnings and cut costs, profit rates for banks did

⁹¹ Robert A. Bennett, “Bankers Dance to a Somber Song,” *New York Times*, October 11, 1981, F4, ProQuest Historical Newspapers The New York Times (1851 - 2005). The ABA, mainly served the interests of large banks, but part of the reason for holding an annual convention was to sell the smaller banks on their legislative program.

not return to their previous levels until the 1990s.⁹² Large banks were in a better position to weather this kind of storm. Perhaps, they were also sophisticated enough to see that in order to survive, they simply had to compete with investment banks for funds. Large banks even challenged previous restrictions on intra and interstate banking, arguing that money market funds were able to draw capital from across the nation and they should be allowed to do the same. Deregulation simply was more burdensome for smaller banks. In an environment of interstate banking, they would surely be swallowed up by large national banks if they were to survive at all. Thus, small banks objected to provisions in the new bill that allowed interstate and inter-industry mergers, seeing it as a direct challenge to the restrictions on branching that allowed them to exist in the marketplace. Furthermore, the greater asset powers granted to thrifts represented increased competition, while granting small banks very little. Larger banks, which were more eager to draw capital from a larger geographic area, tended to support the legislation.⁹³

Another way to measure the effects of deregulation on various depository institutions, argue business finance professors Cornett and Tehranian, is to examine how stock prices of stockholder-owned institutions reacted to announcements indicating imminent deregulation. They found that “both President Reagan’s Housing Commission’s call for a sweeping expansion of the powers of thrift institutions and banks” and “the Senate passage of the Garn-St. Germain bill” resulted in an increase in value of the stock for large banks and large S&Ls, and a decrease in stock price for small banks and small S&Ls. Likewise, when the bill faltered temporarily in the Senate, the

⁹² David B. Humphrey and Lawrence B. Pulley, “Banks’ Responses to Deregulation: Profits, Technology, and Efficiency” *Journal of Money, Credit and Banking*, Vol. 29, No. 1 (Feb., 1997) 73-93 <http://www.jstor.org/stable/2953687> accessed 6/29/09.

⁹³ Robert A. Bennett, “Bankers Dance to a Sombre Song,” *New York Times*, October 11, 1981, F4.

stock prices of large banks and S&Ls dropped, while the stock values for small banks and S&Ls rose. Thus, investors agreed with bank and S&L interest groups about the effect that deregulation might have on their institutions.⁹⁴

Despite small bank objections, and opposition by some in the House, the conference report was accepted. The newly titled Garn-St. Germain Depository Institutions Act of 1982, named for the Chairmen of the Senate and House Banking Committees, was sent to President Reagan's desk. Reagan signed the bill two weeks later, commenting on the law's ability to help the small saver by providing higher returns on savings and enhanced access to loans. Reagan also identified the bill as merely the first step in "our administration's comprehensive program of financial deregulation."⁹⁵ Indicating his desire for additional financial deregulation, Reagan commented that "[u]nfortunately, this legislation does not deal with the important question of delivery of other financial services, including securities activities by banks and other depository institutions."⁹⁶

The final law contained several provisions that affected savings and loans. First, the law provided for emergency assistance to distressed banks and savings and loans. It allowed federal insurers to help troubled institutions through contributions or through the purchase of non-voting stock. The law also allowed the FHLBB to convert state-chartered mutual associations into federally chartered stock associations regardless of state law. Regulators were permitted to arrange for mergers of distressed institutions,

⁹⁴ Marcia Milton Cornett and Hassan Tehranian, "An Examination of the Impact of the Garn-St. Germain Depository Institutions Act of 1982 on Commercial Banks and Savings and Loans" *The Journal of Finance*, Vol. 45, No. 1 (Mar., 1990), 95-111 <http://www.jstor.org/stable/2328811> accessed 6/29/09.

⁹⁵ Ronald Reagan "Remarks on signing HR 6267 into law – Garn-St. Germain Depository Institutions Act of 1982" October 15, 1982 *Weekly Compilation of Presidential Documents*, Volume 18, number 41, 1319-1320.

⁹⁶ Ibid.

with a hierarchy of preferences put in place privileging intrastate over interstate mergers and intra-industry over inter-industry mergers. These emergency provisions were to sunset three years after the date of passage.⁹⁷

The law also addressed net worth problems among savings and loans by implementing an income capital certificate program. To qualify for the program, the institution had to have a net worth of 3% of assets or less, suffer losses for two consecutive quarters, and have at least 20% of its total loans invested in residential mortgages or mortgage-backed securities. FSLIC and the FDIC then could purchase net worth certificates from the institutions, issuing negotiable notes in return.⁹⁸ This maneuver amounted to a slight-of-hand trick to boost net worth without changing the federal budget or requiring cash expenditures from FSLIC. In explaining this provision to a group of lawyers, head FHLBB counsel, Thomas Vartanian said:

In mid-1981, the legal staff of the FHLBB set about the task of devising a means of enhancing the rapidly diminishing net worth of thrift institutions. Limited on the one side by the absence of statutory language providing explicit authority for the FSLIC to purchase equity securities, and on the other by the Administration's concerns that assistance be of a nature that would have a minimal effect on the federal budget, the FHLBB's lawyers designed and implemented the unprecedented income capital certificate ("ICC") program.

Though the S&Ls taking part in the program enjoyed a boost to their net worth on paper, nothing material had changed regarding the financial condition of these institutions.⁹⁹

In terms of liabilities, the law made two important changes. First, it called for the phasing out of all interest rate limits and differentials on all accounts by January 1, 1984.

⁹⁷ Library of Congress, Thomas, "H.R. 6267" <http://thomas.loc.gov/cgi-bin/bdquery/D?d097:1:./temp/~bdviuj:@@L&summ2=m&/bss/d097query.html>.

⁹⁸ Ibid.

⁹⁹ Thomas P. Vartanian, "Remarks Regarding the Depository Institutions Act of 1982" 27; However, journalist Kathleen Day points out that the net worth certificates personally helped thrift executives in stock-owned S&Ls by boosting the stock value. Executives often used their stock as collateral for other investments, she explains, and as their institutions got into net worth trouble, stock prices dropped, and many executives faced calls for more money or collateral. See Kathleen Day, 91.

Secondly, it required DIDC to create, within 60 days of the law's passage, a new account to be offered by depository institutions, competitive with money market mutual funds. The account was to be free of interest rate limits.¹⁰⁰

On the asset side, Garn-St. Germain greatly expanded the investment options available to savings and loans. First, the law eliminated all loan-to-value ratio limitations on residential mortgages, which had previously been set at 80%. Then, the law allowed thrifts to diversify their portfolios into commercial investments. Thomas Vartanian told lawyers "the Act provides the federal thrift with the ability to place up to 90 percent of its assets in commercial-type investments." It allowed S&Ls to invest up to 40% of assets in loans secured by commercial real estate. Also, under the new law, up to 11% of assets could be invested in commercial loans. Institutions could also invest up to 3% of assets in direct equity investments in businesses.¹⁰¹

Finally, the law pre-empted state laws that prohibited mortgage lenders from enforcing due-on-sale clauses in mortgages. While several states had such statutes, this heated issue was perhaps most controversial in California. Sellers in that state, and others, had argued that mortgages were tied to the property, not the individual and thus could be transferred to a new individual when the property was sold. This hurt the lending institutions considerably because it tied them into interest rates of the past, rather than allowing them to initiate a new loan at the going rate when the property was sold. It also deprived institutions of new origination fees. Furthermore, the lack of an enforceable due-on-sale clause in the mortgage contract, made the loan less acceptable for sale on the secondary market. Finally, the statutes against enforcement created a lack

¹⁰⁰ Library of Congress, Thomas, "H.R. 6267" <http://thomas.loc.gov/cgi-bin/bdquery/D?d097:1:./temp/~bdviuj:@@L&summ2=m&/bss/d097query.html>.

¹⁰¹ Ibid.

of parity among institutions, since federal savings and loans were given blanket permission to enforce due-on-sale clauses in 1976.¹⁰² This dilemma had been argued back and forth in California state courts throughout the 1970s, and as the courts tended to rule in favor of sellers, California mortgage lenders had suffered great losses of potential income. The fact that the question was definitively settled in the Garn-St. Germain Act probably speaks to both the extent of hardship faced by California S&Ls and the considerable political influence they obviously wielded.¹⁰³

Garn-St. Germain, passed during a time of severe hardship for the savings and loan industry, brought about profound changes for S&Ls. On the one hand, the legislation offered temporary fixes for severe problems that helped keep institutions afloat until lower inflation and interest rates could come to the rescue. On the other hand, the legislation changed the entire structure of the industry. Many savings and loans would no longer look like savings and loans after instituting the new powers accorded them by the law. With the stroke of a pen, the law deregulated a government-insured industry that had operated under highly restrictive conditions for over 50 years. Combined with the deregulation implemented unilaterally by Pratt and the Bank Board, it represented a drastic and sudden change. In his memoirs, William Seidman, Chairman of the FDIC at the time, laments that Garn-St. Germain allowed S&Ls to invest in practically anything regardless of the risk. "It was another license to gamble with the full

¹⁰² Eric J. Murdock, "The Due-on-Sale Controversy: Beneficial Effects of the Garn-St. Germain Depository Institution Act of 1982" *Duke Law Journal*, Vol. 1984, No. 1 (Feb., 1984), 121-140, <http://www.jstor.org/stable/1372346> accessed 6/29/09.

¹⁰³ Martin Mayer, 47-51; Thomas P. Vartanian, "Remarks Regarding the Depository Institutions Act of 1982" 32.

faith and credit of the U.S. government, supplied through insured deposits,” he complained.¹⁰⁴

Furthermore, deregulation did not stop at the federal level. States such as Arizona, California, Texas, Florida, Ohio, and Maryland, fearing that their state-chartered institutions would convert to federal charters to enjoy the benefits of deregulation, passed similar deregulatory legislation, in some cases even before the Garn-St. Germain Act was passed. Some state laws surpassed the federal one in terms of leniency.¹⁰⁵

The Reagan administration cannot be judged for the ailing condition of S&Ls when it took office. The problem was not of their making. However, one can evaluate how the administration dealt with the situation it inherited. This is especially true because the Reagan administration’s strong agenda control and considerable political power rendered it largely able to implement the policies it supported and equally able to close down options it opposed. Therefore, sudden and drastic deregulation was not so much a compromise struck, but a path chosen that was completely consistent with the administration’s ideology, interests, goals, and support groups. The S&L industry had considerable influence with both parties, and Pratt and his team rode the wave of deregulation that allowed them to throw enough bones to appease this important constituency. During the 1980s, fervor for deregulation and faith in the market, already strong during the 1970s, skyrocketed. Reagan’s inaugural pronouncement that “government is not the solution to our problem; government is the problem,”¹⁰⁶ became

¹⁰⁴ L. William Seidman, 181.

¹⁰⁵ Lenny Glynn, “Who Really Made the S&L Mess?”; Norman Strunk & Fred Case *Where Deregulation Went Wrong: A Look at the Causes Behind Savings and Loan Failures in the 1980s* (U.S. League of Savings Institutions, 1988) 58-9.

¹⁰⁶ June 20, 1981, Ronald Reagan’s Inaugural Address, available from <http://www.reaganlibrary.com/reagan/speeches/first.asp>

the guiding principle in several policy areas, including financial reform. However, as the adage goes, perhaps Richard Pratt should have been more careful what he wished for. He did indeed get it. Deregulating to the extreme was perhaps too drastic, for an industry that had been protected, micro-managed, and insured by the federal government since the New Deal.

CHAPTER 5

THE COLLAPSE AND ITS MEANING

Ironically, the Garn-St. Germain Act, with its badly needed emergency relief provisions, became law just as conditions were on the verge of improving for savings and loans. During the second half of 1982, the economy began to recover, and interest rates dropped slightly. In addition, the launching of the money market account authorized by Garn-St. Germain, brought in a huge influx of capital. In its annual publication of statistics, the U.S. League noted that, "In only two and one-half weeks between its authorization and year-end, the money market account attracted nearly \$34 billion, 6% of total deposits."¹ From 1982-1985, funds continued to pour into these accounts, with record growth in deposit levels during 1983 and 1984, notwithstanding a drop in the U.S. personal savings rate.² Furthermore, mortgage lending reached unprecedented heights from 1983-1985. This was fueled partly by the drop in mortgage interest rates, which encouraged consumers, who may have delayed purchasing in the high rate environment, to buy homes again. Private housing starts in 1983 outnumbered the previous year by almost 8 million, and the sale of existing homes was about 36% higher than in 1982.³ The better rates also encouraged borrowers to refinance high interest rate loans made during the credit crunch years of 1979-1982.⁴ At the same time, investors displayed a renewed interest in mortgage-backed securities, as the yields for corporate bonds and utilities moved closer to the rate of return on conventional mortgages. S&Ls sold a

¹ '83 *Savings and Loan Sourcebook* (United States League of Savings Associations, 1982) 6.

² 1984 *Savings Institutions Sourcebook* (United States League of Savings Associations, 1984) 5-7, 22.

³ *Ibid.*, 39.

⁴ 1985 *Savings Institutions Sourcebook* (United States League of Savings Institutions, 1985) 9-10.

record number of loans from their portfolios. All this primary and secondary market activity made for record mortgage portfolio turnover ratios—25% in 1983,⁵ 26% in 1984,⁶ and 34% in 1985. Portfolio turnover helped to improve earnings, as new loans took the place of old, poorly performing ones. New loans also produced income through loan origination fees.⁷

There were also many signs in the 1980s that the S&L business was changing. S&Ls were not the small self-help institutions from which they originated, and they were not the simple collectors of savings and writers of mortgages that the New Deal had called for either. They were becoming integrated into the U.S. capital market. For example, in its 1985 publication of statistical data, the League advised that institutions might want to use futures contracts to hedge their interest rate risk.⁸ Also, associations were selling an increasing number of their loans on the secondary market, largely to federal agencies such as Fannie Mae, Ginnie Mae, and Freddie Mac, in exchange for mortgage backed securities. This trend became particularly pronounced in 1986 with the creation of the real estate mortgage investment conduit (Remic), which provided a tax-exempt means to pool mortgage backed securities. The number of loans sold by associations increased 76.7% between 1985 and 1986. This changed the way S&Ls operated. As noted by the U.S. League in 1987, “Recently, savings institutions also have become more interested in originating mortgage loans for subsequent sale to investors such as pension funds and insurance companies.”⁹ S&L borrowers were no longer

⁵ 1984 *Savings Institution Sourcebook*, 9. This was the highest seen by the industry since 1950.

⁶ 1985 *Savings Institutions Sourcebook*, 9-10.

⁷ 1984 *Savings Institutions Sourcebook*, 9.

⁸ 1985 *Savings Institutions Sourcebook*, 11, 15. The League credit Ginnie Mae with creating the first financial futures contract.

⁹ 1987 *Savings Institutions Sourcebook* (United States League of Savings Institutions, 1987) 10.

financed mainly by personal savings from their fellow citizens. The money for their loans came from a variety of sources.

The industry looked remarkably healthy from 1982-1985. It appeared to have survived the hard times of 1979-1982 and remodeled itself for success. In 1984, industry profits came in at over \$1 trillion and 1985 profits were record-breaking. However, there were indications that all was not well. For example, the alarming rate of growth of some institutions worried regulators, as did the new investments made by a number of associations using the expanded powers that the Garn-St. Germain Act granted them. This prompted the FHLBB to change reserve requirements for FSLIC-insured savings institutions, effective March 31, 1985. New reserve requirements were to be calculated quarterly, based on each institution's growth and the percentage of high risk assets on its books. The FHLBB seemed to be concerned about the growth rates and investments of some institutions, and though the industry as a whole earned record earnings in 1985, the League's publication noted that "about 90% of savings institutions made a profit in 1985." Little explanation was provided for the unprofitable 10%.¹⁰ News about the FSLIC insurance fund also proved worrisome:

The FSLIC faces many new pressures caused by such forces as financial deregulation, which has increased competition for savings and greatly expanded investment options for all insured institutions. As a result, Congress is increasingly concerned about the viability of deposit insurance...¹¹

The Board also restricted direct investments to 10% of association assets or twice an institution's net worth. Finally, the Board imposed quarterly premium assessments of

¹⁰ Ibid., 14.

¹¹ Ibid., 17.

1/32 of 1% on all FSLIC-insured institutions to add about \$1 billion to the insurance fund.¹²

This disconnect between the idea of record profits and the phenomenon of worried regulators can be explained partly by a lag in the numbers. New, risky investments, such as acquisition, development and construction loans, can originally look quite profitable because they are loaded with up-front fees that associations report as income. In addition, often the first few years of payments are built into the loan, almost guaranteeing that it will perform well early. Losses from unwise decisions can take years to work their way into annual profit figures. In addition, institutions grew dangerously quickly because they could raise an immense amount of brokered funds. DIDMCA facilitated this by increasing the limit on deposit insurance, and Dick Pratt encouraged it by removing the restrictions on the amount of brokered funds an institution could raise. Thus, in no time at all, an institution could raise enormous funds, invest those funds in unsound loans, and appear to be incredibly financially healthy, when in reality, it was extremely vulnerable.¹³

Profits in 1986 proved much lower than in the previous year. In its annual statistical report, the League tried to justify the industry's performance:

Although profitable institutions had an exceptionally good year, about 2% of the institutions that did not make a profit caused a severe drag on the business' overall earnings. These institutions, which are administered by the FHLBB through its Management Consignment Program, lost about \$3 billion last year. Without counting the performance of the MCP institutions, the business' return on assets would have been 0.35% and after-tax net income would have come close to equaling the record \$3.92 billion.¹⁴

¹² Ibid.

¹³ Martin Mayer,

¹⁴ Ibid., 15.

While this addressed the 2% of institutions that caused the largest losses, it did little to explain the other 18% that failed to earn a profit. Obviously something was going wrong in the industry. The report again discussed the strain on FSLIC resources and expressed that “By the spring of 1987, Congress was close to taking final action on legislation to recapitalize the FSLIC.”¹⁵

By the end of 1987 record earnings had turned into record losses, caused by poor investment decisions, plunging oil prices, the bursting of the real-estate bubble in many regions, and gambling, fraud and mismanagement encouraged by deregulation. The industry lost \$6.8 billion that year, with about 1/3 of all savings institutions suffering losses. The U.S. League tried to argue that even after restructuring, the S&L industry was “by and large still hostage to the uncertainties of interest rate movements.” They claimed the increase in rates in 1987 hurt the industry’s profitability by lowering loan originations, thereby lowering loan fee income and profits from the sale of assets. However, this failed to explain why 1/3 of the industry remained unprofitable. Even the League had to attribute much of the loss to problems associated with deregulation:

Eventually, however, economic forces began to turn against a number of institutions causing large losses in their loan portfolios. Victimized by a plunging oil economy, institutions in Texas bore a substantial share of these losses. In some cases, mismanagement or fraud accounted for severe financial difficulties or failures.¹⁶

Another problem thrifts faced during this time was continuing competition from commercial banks in the mortgage market. As discussed earlier, banks suffered from increasing competition in all areas. As restrictions on interstate banking were relaxed, banks which had always enjoyed strong positions in their communities faced competition

¹⁵ Ibid., 20.

¹⁶ Ibid., 14-15.

from outside their region. U.S. commercial banks also faced competition from international banks and investment banks. Bank profitability buckled under the strain of this intense rivalry, and the 1980s saw the highest bank failure rate since the Great Depression. The number of government insured commercial banks fell from 14,512 at the end of 1984 to 10,514 by the end of 1994. The drop in numbers reflected institutions taken over by the government, voluntary closures, and mergers with or acquisitions by other banks. The number of remaining banks also included S&Ls and mutual savings banks that had converted to commercial bank charters. Given the vulnerable condition of many commercial banks, competing with S&Ls, which were themselves vulnerable, represented one of the best options. In fact, several factors gave banks a competitive edge over S&Ls. For example, banks were not burdened by a portfolio of fixed-rate, low-yielding loans from the past the way that S&Ls were. Therefore, they could afford to offer lower loan rates. Furthermore, banks had the benefit of hindsight. They understood how S&Ls got into earnings trouble and could protect themselves from such problems by using the newly available adjustable rate mortgages and by selling loans on the secondary market. Commercial banks represented formidable competition.¹⁷

The mounting S&L industry losses continued to take their toll on FSLIC resources. Despite the \$3 billion raised from special premium assessments, FSLIC's reserve fund proved grossly insufficient to handle the rapidly growing number and size of troubled institutions. In August of 1987, Congress passed the Competitive Equality Banking Act of 1987, which authorized FSLIC to borrow up to \$10.8 billion from the U.S. Treasury.¹⁸ Initiated by the efforts of Undersecretary of the Treasury George Gould,

¹⁷ Donald D. Hester, "U.S. Banking in the Last Fifty Years: Growth and Adaptation," 16-17.

¹⁸ *Ibid.*, 18-19.

this plan was intended as a bail-out for S&Ls that would supply FSLIC with extra funds and provide for the closure of insolvent associations. It represented an earnest effort to solve the industry's problems. The S&L industry, however, strongly opposed this deal, and called on Speaker of the House, Jim Wright (D, TX) to support their case. The League opposed bailout funds in general and insisted that the approximately \$10 billion of recapitalization being considered was more than enough. Most of the industry remained healthy, the League argued. The final bill provided \$10.8 billion to FSLIC, and called for 3 years of supervisory forbearance for well-managed S&Ls with weak capital levels. It also mandated that regulators supervising thrifts in depressed areas use more lenient guidelines.¹⁹ To a large degree, the industry got its way. While the additional funds were supposed to be used to take action towards troubled thrifts, the regulatory forbearance stood in the way of accomplishing this. As savings and loan historian David Mason has argued, "regulatory forbearance was interpreted as a signal for regulators to 'back off.' It "had the affect of allowing poorly run S&Ls to engage in riskier lending and grow larger. The result was that when these institutions did finally fail, the cost to the FSLIC was significantly higher."²⁰ Another genuine attempt at solving the industry's problems had been thwarted by the industry itself, and in fact, the limits placed on regulators exacerbated the problem and raised the costs of the final resolution.

By 1987, 11% of the S&L industry had fallen into insolvency. The worst problems occurred in Texas, where 109 institutions were insolvent and accounted for more than half of the nationwide losses for S&Ls that year. Texas was hit exceptionally

¹⁹ L. William Seidman, *Full faith and credit : the great S & L debacle and other Washington Sagas* (Times Books, 1993) 194; Glyn Davies, *A History of Money: From Ancient Times to the Present Day* (University of Wales Press, 2002); David Mason, 232-233.

²⁰ David Mason, 233-234.

hard for a number of reasons. First, the state's economy was built around the oil industry and as oil prices plummeted, the whole state economy fell apart. This eventually led to a collapse of the real estate market, which hurt thrifts directly. In addition, Texas institutions had engaged in some of the riskiest investments. The state had deregulated its depository institutions well before the passage of DIDMCA. Texas S&Ls could invest in just about any venture and they did. Thus, when the local economy collapsed, many S&Ls became insolvent. In 1988, facing insufficient FSLIC resources and growing insolvencies, the Board implemented "the Southwest Plan," an attempt to sell or merge troubled Texas S&Ls to investors who might return them to profitability by consolidating costs. However, since liabilities for these troubled institutions were greater than assets, to convince acquirers to participate, the Board had to throw in huge incentives, such as loans and guarantees to compensate buyers for losses. The enticement for buying these thrifts also lay in tax benefits, since buyers could write off the acquired institutions losses if the purchase became final before January 1, 1989. This led to a chaotic barrage of mergers during the final days of 1988. Purchasers played it smart, waiting until the last minute to get incredibly good deals. For example, Ronald Perleman, the chairman of Revlon, organized a group that spent \$315 million buying 5 thrifts, and received \$897 million in tax benefits. The Board arranged for the purchase of 181 S&Ls under the Southwest Plan, at a cost of \$32 billion. The excessive costs of this program gained the attention of many in Congress and convinced them of the need for a true industry bailout.²¹

²¹ David Mason, 234-236; Michael Waldman and Staff of Public Citizens' Congress Watch, *Who Robbed America? A Citizen's Guide to the Savings and Loan Scandal* (Random House, 1990) 85-90; Paul Zane Pilzer, *Other People's Money: The Inside Story of the S&L Mess* (Simon and Schuster, 1989) 204-205.

By the end of 1988, even though 205 S&Ls had been resolved, about 250 institutions were still insolvent and the largest ones were losing \$1 billion per month. Also, FSLIC's net worth fell to negative \$75 billion by the end of the year.²² By 1989, the Chairman of FSLIC estimated that 340 S&Ls were insolvent and that 800 institutions possessed assets worth \$400 billion that needed to be sold, merged or liquidated.²³ The full effects of extremely rapid growth and risky investments were being felt. The collapse had come, but the Reagan administration had managed to avoid dealing with it. That would be a task for incoming President George Bush.

In August of 1989, Congress passed the Financial Institution Reform, Recovery and Enforcement Act of 1989 (FIRREA). The law created the Resolution Trust Corporation. Funded with \$50 billion, the organization was charged with the task of selling off the assets of insolvent thrifts. The \$50 billion was financed off the budget, through the sale of long term bonds and higher premiums and taxes from the S&L industry. FIRREA also did away with the FHLBB and FSLIC. The Board was replaced by the Office of Thrift Supervision, a new agency within the Treasury Department. Deposit insurance for S&Ls became the responsibility of the FDIC, which created a new fund called SAIF, the Savings Association Insurance Fund, to administer it. The law also called for stricter capital requirements for institutions by June of 1991, and more stringent accounting rules, such as the elimination of goodwill as equity. FIRREA sought to return S&Ls to their housing focus, and thus required institutions to devote at least 70% of assets to investments related to residential housing in order to be considered a qualified thrift lender. The law also created stronger regulations about other investments, calling

²² David Mason, 241-243.

²³ Glynn Davies, 535-540..

for institutions to divest themselves of junk bond holdings and to reduce commercial real estate investments. State-chartered S&Ls had to limit their activities to those permitted for federally chartered thrifts, regardless of how lenient state regulations might be.²⁴ The legislation represented a complete change of philosophy about savings institution regulation. The faith in free market outcomes had temporarily faltered.

David Mason has described the interesting politics behind this legislation. The League, he argues, lost most of its power to influence the legislation because the industry, which had suffered from internal divisions since the mid 1950s, became radically divided in opinion. Weak S&Ls opposed the strict provisions of the bill, while healthy associations “were tired of opposing efforts to improve the industry,” explains Mason. The rift between the two was so large that the three largest California institutions even hired their own lobbyists to help them fight for strict capital and accounting standards.²⁵ The significant power of the League had been nullified by its own implosion.

The conditions for S&Ls had been very harsh for 20 years. Savings and loans had suffered from flawed and inflexible regulation, high inflation, unfavorable interest rate fluctuations, mounting competition, and structural economic change that called into question their reason for existence. Deregulation also proved to be a strain, as it compelled thrifts to pay market rates of interest, and stretched the skill set of the industry’s executives by requiring them to invest in areas with which they had little experience. Even the industry bailout stressed S&Ls by instituting stricter capital requirements on already unhealthy associations. Survival represented a difficult task. Many thrifts merged with larger ones or converted to commercial bank charters. One

²⁴ David Mason, 241-247.

²⁵ Ibid.

strategy for survival, described by bank CEO, Anat Bird in 1993, was to become highly efficient at originating, servicing, and selling mortgage loans. This favored larger institutions. By the late 1980s, the U.S. had developed a national mortgage market, with Fannie Mae, Ginnie Mae, and Freddie Mac playing the role of financial intermediary previously carried out by S&Ls. The deposit market too had been nationalized. The need for a separate and unique S&L industry simply no longer existed. Many S&Ls chose to convert to bank charters or to merge with larger institutions. Of the 4000 S&Ls and mutual savings banks that existed in 1985, only 2300 remained in 1993.²⁶ By March of 2009, only 801 remained.²⁷

To understand why the S&L industry experienced a collapse of such epic proportions instead of a gradual phaseout, one must understand the flaws inherent in the deregulatory program pursued by the Reagan administration. Reagan inherited a sick and troubled thrift industry in 1981, ailing from regulations that prohibited healthy investment diversification and subjected S&Ls to interest rate risk. The high-inflation, high-interest rate environment of the late 1970s and early 1980s acted as a catalyst, exposing all the flaws and vulnerabilities created by previous regulation. Something had to be done. However, the steps taken by the Reagan administration focused more on avoiding a solution than on crafting one. The emergency relief provisions pursued by the Reagan administration and the Bank Board during the early 1980s made sense. Their purpose was to help thrifts through a time of difficult economic conditions. Some of the regulations issued also made sense, such as allowing S&Ls to write adjustable rate

²⁶ Anat Bird, *Can S&Ls Survive? The Emerging Recovery, Restructuring & Repositioning of America's S&Ls* (Bankers Publishing Company and Probus Publishing Company, 1993).

²⁷ Industry Aggregate Report, March 2009, Office of Thrift Supervision, <http://files.ots.treas.gov/32110900.pdf> accessed 6/25/09.

mortgages to protect themselves from interest rate fluctuation, and permitting a certain amount of careful investment diversification so that a slump in the housing market did not cause severe strain for the industry. However, the steps taken by the Reagan administration went far beyond those ends and ultimately worsened the magnitude of the industry's problems exponentially.

The most obvious problem with the legislative and regulatory reform program was that it allowed distressed S&Ls to continue doing business. The capital assistance program contained in the Garn-St. Germain Act, and Bank Board regulations lowering net worth requirements permitted FSLIC to delay taking action on insolvent institutions. While this might have been good for the budget numbers in the short run, it created larger losses in the long run.²⁸ Furthermore, ignoring the problem of troubled institutions had negative effects on the whole financial industry, argues former FDIC chairman, Bill Seidman. Insolvent thrifts tended to do economically irrational things to stay alive, including offering unreasonably high rates of return to attract deposits. Depositors did not need to worry about how an S&L could afford to pay such high returns because their money was insured by the federal government. Since the Bank Board removed the limit on brokered funds and DIDMCA raised deposit insurance to \$100,000, attracting huge capital inflows proved easy to any institution willing to offer higher rates than competitors. "They posed unfair, and recklessly irresponsible, competition to banks,"

²⁸ Frederick E. Balderston, *Thrifts in Crisis: Structural Transformation of the Savings and Loan Industry* (Ballinger Publishing Company, 1985) 106.

Seidman complains. "...they helped debase credit standards and destabilized the system to the point of threatening the collapse of some of its strongest players."²⁹

Another problem with abrupt and sudden deregulation lay in thrift executives' lack of experience and savvy in the field of investing. While executives at the largest thrifts might have had a good command of investment instruments and markets, most thrift executives did not. They had spent their careers conducting the kind of simple business mandated by the New Deal regulatory framework: they collected deposits and wrote home loans. Even before the Garn-St. Germain Act freed S&Ls to invest directly in almost any business, Pratt's regulations encouraged thrifts to sell poorly performing loans by permitting them to spread losses over the life of the loans. For tax purposes, however, institutions could claim and deduct all of the loss at once, entitling them to recover tax revenues from previous years.³⁰ This led thrift executives directly to Wall Street to sell their loans.

Salomon Brothers was the first investment firm to securitize mortgages in 1977. In their opening mortgage deal, Salomon bought loans from Bank of America and sold them to regular Salomon investors, such as insurance companies. From this beginning, the firm created a small mortgage trading department. The department head, Bob Dall, believed that securitizing mortgage could be an effective means of moving money from the Rust Belt, where deposits exceeded mortgage demand, to the Sunbelt, where demand exceeded deposits. The undertaking, however, proved unsuccessful at first. In his memoirs, former Salomon bond trader, Michael Lewis, described the initial lack of

²⁹ L. William Seidman, 176. Fabritius and Borges add that stressed S&Ls hurt the reputation of all S&Ls, which meant consumers demanded higher returns on their deposits. See Fabritius and Borges, chapter 6.

³⁰ R. Dan Brumbaugh, Jr., *Thrifts Under Siege: Restoring Order to American Banking* (Ballinger Publishing Company, 1988) 62.

interest in mortgage securities. “The mortgage market was the financial equivalent of a ghost town: Nothing moved, nothing traded” In fact, by 1980 many at Salomon Brothers wanted to close down the unprofitable department.³¹

All that changed in 1981 when S&Ls were permitted to deduct loan losses to recover past tax dollars. Suddenly, Salomon Brothers, the only investment firm on Wall Street to have a mortgage trading department, was buzzing with S&L activity, buying loans from thrifts and selling them mortgage bonds in return. However, S&L managers and owners were in way over their heads when it came to conducting business on Wall Street. They sold their loans for too little and bought bonds for too much. In addition, many managed institutions on the brink of failure and were thus willing to try gambling with investments such as junk bonds that they did not fully understand. “Thrift presidents were desperate.” Lewis explained. “They didn’t know the mentality of the people they were up against. They didn’t know the value of what they were selling...The only thing the thrift managers knew was how much they wanted to sell.” From 1977-1986, savings and loans portfolio of mortgage bonds grew from \$12.6 billion to \$150 billion. “The S&L manager had become America’s biggest bond trader,” argued Lewis. “He was also America’s worst bond trader. He was the market’s fool.”³² Journalist Martin Mayer echoes Lewis’ sentiments about the vulnerability of thrift executives when dealing with Wall Street:

The debilitation of the industry is in large part the result of its contact with a more intelligent, more sophisticated, more amnesiac, more mechanical, more

³¹ Michael Lewis, *Liar’s Poker: Rising Through the Wreckage on Wall Street* (W.W. Norton & Company, 1989) 86-100.

³² *Ibid.*, 101-114. This point is also made in Steven K. Wilmsen, *Silverado: Neil Bush and the Savings & Loan Scandal*, (National Press Books, 1991) 52.

predatory form of life. It was like the Indian tribes when white settlers brought them measles.³³

Likewise, when Garn-St.Germain granted S&Ls the power to invest directly, some thrift managers stretched into fields about which they knew little. They invested in wild plans that had been prohibited before deregulation, and promised to pay large returns, including windmill farms, race horses, and pornographic libraries.³⁴ They also invested in commercial real estate projects, which seemed like a reasonable alternative since thrifts had experience in real estate. However, the acquisition, development and construction (ADC) loans S&Ls wrote carried much risk. Institutions often financed 100% of the construction project, allowing the borrower to pay interest only until completion of construction. At times, the institution financed more than 100% of the appraised value of the project because they built the first several years of payments into the loans. On the balance sheets, S&Ls counted these payments as income, even though they were made directly from loan proceeds. S&Ls carried all the risk, since the borrower, who was frequently a close friend or business associate of the S&L owner, could walk away from the project at any time and lose nothing.³⁵

Unfortunately, deposit insurance encouraged these strategies. The government's guarantee of deposits allowed troubled, even insolvent institutions, to continue to attract funds. S&Ls had a blank check when it came to raising capital, and the ability to gamble with billions of dollars. This was especially true because supervision of institutions

³³ Martin Mayer, 74.

³⁴ L. William Seidman, *Full Faith and Credit*, 191.

³⁵ Norman Strunk and Fred Case, *Where Deregulation Went Wrong: A Look at the Causes Behind Savings and Loan Failures in the 1980s* (U.S. League of Savings Institutions, 1988) 75-77. Martin Mayer, 12-13, 277; Michael Waldman 35-40; R. Dan Brumbaugh, Jr., *Thrifts Under Siege: Restoring Order to American Banking* (Ballinger Publishing Company, 1988) 153.

proved lax. If the S&L lost its bets, it was no worse off, because it had been insolvent and on the brink of failure anyway. If the S&L won its bets, it might survive. As former FHLBB economist R. Dan Brumbaugh has noted, “An adage that developed in the 1980s was that ‘heads the savings and loans won, tails the FSLIC lost.’”³⁶ Former U.S. League President, Norman Strunk, and former California Savings League economist, Fred Case, have argued that “excessive growth has long been recognized as one of the best predictors of financial institution failures. In the long term, it resulted in an “explosion of problem assets.”³⁷ Growth facilitated by deposit insurance significantly increased the magnitude of the S&L collapse.

The new industry environment, brought about by radical deregulation and gambling for resurrection, attracted a different kind of person to the S&L business. He was no Jimmy Stewart.³⁸ These were gamblers who, under the new capital and net worth rules, could buy an S&L with a very small cash investment. With little money of their own on the line, they could then gamble with what amounted to taxpayer funds. This created even more reckless speculation, and there is convincing evidence that it contributed heavily to the S&L disaster. For example, of the 72 associations placed in management conservatorship between March of 1985 and July of 1987, more than half were either managed or owned by people who had entered the business during or after 1980.³⁹ The new cast of S&L owners also frequently included builders, land developers, and real-

³⁶ R. Dan Brumbaugh, Jr., *The Collapse of Federally Insured Depositories: The Savings and Loans as Precursor* (Garland Publishing, Inc., 1993) 10.

³⁷ Norman Strunk & Fred Case, 71.

³⁸ In the famous movie, “It’s a Wonderful Life,” actor Jimmy Stewart played George Bailey, the honest, hard-working owner of Bailey Building and Loan. His thrift was a small, simple one that existed to serve his local community. It did not make him rich.

³⁹ Norman Strunk and Fred Case, 89; L. William Seidman, 179; R. Dan Brumbaugh, *Where Deregulation Went Wrong* 153.

estate entrepreneurs, who bought associations in order to make loans to themselves.⁴⁰

The limitless amount of available funds and lack of restrictions on what could be done with the money drew in gamblers, speculators, and the dishonest like a bright light attracts mosquitoes. Former FDIC chairman, William Seidman commented that “As a lawyer as well as an accountant, if I had been asked to defend these gamblers in court, I might well have used the defense of entrapment.”⁴¹

How much of the industry collapse should be attributed to fraud or other illegal activities remains controversial. A small group of criminologists has argued that “systematic political collusion--not just policy error-- was a critical ingredient in this unprecedented series of frauds.”⁴² The combination of increasing deposit insurance and deregulation opened the door to white-collar crime of an unusual nature. Whereas most corporate crime victimizes a company’s workers or consumers, S&L crime victimized the criminals’ own institutions and industry, they have asserted. William Black has referred to these corrupt S&Ls as control frauds. “A control fraud,” he explains, “is a company run by a criminal who uses it as a weapon and shield to defraud others and makes it difficult to detect and punish the fraud.” He contends that the savings and loan scandal consisted of a compilation of control frauds that proved severe enough to threaten the health of the overall economy.⁴³ Calavita, Pontell, and Tillman go so far as to argue that S&L crime fit the definition of organized crime, in that it was “premeditated, organized, continuous, and facilitated by relationships between its perpetrators and public

⁴⁰ Norman Strunk and Fred Case, 90.

⁴¹ L. William Seidman, 179.

⁴² Kitty Calavita, Henry N. Pontell, Robert H. Tillman, *Big Money Crime: Fraud and Politics in the Savings and Loan Crisis* (University of California Press, 1997) 1.

⁴³ William K. Black, *The Best Way to Rob a Bank is to Own One* (University of Texas Press, 2005) 1.

officials.”⁴⁴ Journalists Stephen Pizzo, Mary Fricker, and Paul Muolo too have argued that fraud explained a significant number of S&L failures and that the FBI failed to see this because they treated each institution separately, instead of looking across thrift failures for commonalities. “We never once examined a thrift—no matter how random the choice— without finding someone there whom we already knew from another failed S&L,” they explain. Through the course of their examinations they claim to have uncovered, “mobsters, arms dealers, drug money launderers, and the most amazing and unlikely cast of wheeler-dealers that ever prowled the halls of financial institutions.”⁴⁵

In some cases, it proved difficult to differentiate between a desperate thrift gambling for resurrection and criminal activity. This line became blurred because regulators allowed such questionable investment practices and accounting standards in order to avoid pursuing genuine solutions. Furthermore, esteemed professionals, outside the industry, facilitated and put their stamps of approval on both the speculation and the fraud. They did so, because they were paid well. Appraisers overvalued property values. Brokers earned high commissions by sending deposits to unsound institutions and by selling S&Ls risky, overpriced assets such as junk bonds. Lawyers stopped regulators from doing what needed to be done. Regulators, who planned to return to the industry after their stint in regulation, became beholden to the industry and failed to crack down on institutions when they should have.⁴⁶ Accountants certified financial records that

⁴⁴ Ibid., 83.

⁴⁵ Stephen Pizzo, Mary Fricker, Paul Muolo, *The Looting of America's Savings and Loans* (McGraw Hill Publishers, 1989) 6-10.

⁴⁶ L. William Seidman, 192-3, Lenny Glynn, “Who Really Made the S&L Mess?” in Robert Emmet Long, editor, *Banking Scandals: The S&Ls and BCCI*, (The H.W. Wilson Company, 1993) 18.

were seething with unacceptable accounting practices.⁴⁷ Finally, some members of Congress, as the recipients of S&L largesse, interfered when regulators attempted to do their jobs. The most famous and obvious example of this was the “Keating 5.”⁴⁸

The massive sums of money paid by S&Ls to outside professionals and public officials created a contingency of powerful interests who stood to benefit from the flawed system. These people all had a financial stake in preventing the resolution of the thrift crisis and maintaining the system that attracted gambling and fraud. In discussing accounting problems at the famous Silverado Savings and Loan in Texas, Steven Wilmsen commented that “for some reason, delight for objective accounting flew out the window in the 1980s, to be replaced by delight for money. It was greed, pure and simple. But the greed didn’t appear out of thin air. It was produced and nurtured by the Reagan administration’s deregulation.”⁴⁹

Problems in the industry were also exacerbated by Reagan administration budget cuts. Just as the S&L industry was suddenly and radically deregulated, and just as an increasing number of thrifts approached or reached insolvency, budget cuts significantly reduced bank examination staff and salaries. The Reagan administration, which was eager to reduce nonmilitary spending, believed that part of deregulation involved cutting supervision. Between 1980 and 1985, the number of bank examiners per troubled thrift

⁴⁷ By 1990, the FDIC and RTC had begun lawsuits against 21 accounting firms for fraud and negligence in an attempt to recover \$1.5 billion. See Steven K. Wilmsen, *Silverado: Neil Bush and the Savings & Loan Scandal*, (National Press Books, 1991) 173.

⁴⁸ The Keating 5 was a group of five senators, 4 of them Democrats and 1 Republican: Alan Cranston (D,CA), Dennis Deconcini (D,AZ), John Glenn (D,OH), John McCain (R,AZ), and Donald Riegle (D,MI). They all received political contributions from Lincoln Savings and Loan owner, Charles Keating, and were accused of intervening when the FHLBB attempted to take regulatory action against the S&L. Ultimately, a Senate Ethics Committee determined that John McCain and John Glenn had only shown poor judgment, but Cranston, Deconcini, and Riegle had improperly interfered with regulators. The committee officially reprimanded only Alan Cranston.

⁴⁹ Steven K. Wilmsen, 173.

fell by 50%. FHLBB chairman, Ed Gray, tried to warn the administration about the problem, but former FDIC chairman William Seidman recalls that “Stockman had no patience with warnings that the Federal Home Loan bank Board needed more supervisors. No matter how many requests were made to him to focus on the troubles of the S&Ls, he passed the problem down the chain of command, and, as far as I know never took any interest in it.” Treasury Secretary Donald Regan too balked at Gray’s pleas for more supervisors.⁵⁰ In 1984, the average S&L examiner earned \$24,775 per year, while even his or her public sector counterparts in bank examination earned \$30,750-\$37,900. These salaries were so low that the government struggled to fill even the senior positions. Fewer than 700 examiners were charged with supervising about 3500 S&Ls. This proved grossly inadequate. Given the enormous expansion of S&L investment powers, the development of creative accounting tricks, and the number of S&Ls in distressed financial condition, the examination staff needed to grow, not shrink. Furthermore, the system needed sophisticated, well-trained examiners. The paltry compensation offered would never attract such people, who could earn much more in the private sector. Many institutions went unexamined for years, giving S&L owners the idea that they were immune to regulations, and could get away with anything.⁵¹

Ironically, one of the worst problems with the deregulatory campaign of the 1980s was that it did not go far enough. If the Reagan administration and the Bank Board were determined to radically and abruptly deregulate the S&L industry, they could have finished the job by eliminating or changing the terms of deposit insurance. As Dan Brumbaugh argues, deposit insurance creates the need for regulation because it eliminates

⁵⁰ L. William Seidman, 181-2; Paul Zane Pilzer, 163.

⁵¹ Martin Mayer, 143-145.

all forms of market discipline. Savers and brokers do not tend to investigate the soundness or past results of the institutions in which they deposit their funds when those funds are backed by the full faith and credit of the U.S. government.⁵² Thus, institutions could and did act recklessly with depositors' funds, without hurting their chances of attracting new capital in the future. This appreciably increased the eventual resolution costs. Another problem with deposit insurance was that the rate charged was equal for all institutions, whether they invested conservatively or speculatively. This had always been a problem with deposit insurance and was the reason some people opposed the idea before its implementation in the 1930s. In particular, more conservative eastern bankers feared that their premiums would have to pay for the excesses of wildcat western bankers. To a large degree, however, close regulation of financial institutions kept this from happening.⁵³ After deregulation, sound institutions did indeed find themselves paying the same as troubled gambling institutions that posed a much greater threat to the FSLIC fund.

These fundamentals of deposit insurance were far from abstruse, and clearly the Reagan administration and the FHLBB were aware of the perverse incentives they created with the combination of deregulation and deposit insurance. In fact, the Garn-St. Germain Act required the FHLBB to study deposit insurance and present Congress with a report of the Board's recommendations. Eight months later, as Richard Pratt was leaving his post, he and the Board submitted their *Agenda for Reform*. It called for reform in six areas of the deposit insurance system "in order to bring that system into equilibrium and

⁵² Dan Brumbaugh, *Where Deregulation Went Wrong*, 6-8; James K. Glassman, "The Great Banks Robbery in Robert Emmet Long, editor, *Banking Scandals: The S&Ls and BCCI*, (The H.W. Wilson Company, 1993) 24-26; Ned Eichler, *The Thrift Debacle* (Berkeley: University of California Press, 1989) viii.

⁵³ Paul Zane Pilzer, 37-40.

control the risk exposure of the Federal Savings and Loan Insurance Corporation (FSLIC) while maintaining the benefits of deregulation to the public.”⁵⁴ The suggestions included a switch to insurance premiums based on risks taken by each institution, rather than the use of flat premiums based on deposit volumes. Complaining that the deposit insurance system “bears no rational relationship to risk imposed on the FSLIC by the insured institution,” the Board explained that risk-based premiums would attempt to reflect interest rate risk, default risk, and net worth levels. The Board also suggested that some of the responsibility for insuring deposits be transferred to the private commercial insurance sector. This would be beneficial, the Board argued, because it would impose market discipline on S&Ls. Depositors might not concern themselves with their institution’s soundness, but a private insurer surely would, the Board argued. “Private insurance should provide incentives to manage risk through premium pricing and other forms of competitive pressure.”⁵⁵

The Pratt Bank Board suggested other reforms to shore up deposit insurance. They recommended better accounting standards, such as requiring current value information, so that “depositors, investors, and managers are fully informed about the financial condition of associations.” This was ironic, coming from Pratt, since just two years earlier; he had authorized the shift from Generally Accepted Accounting Principles to Regulatory Accounting Principles. The Board also suggested holding directors and managers more responsible for “prudent stewardship of the deposits insured by the FSLIC,” and encouraging institutions to build adequate capital reserves, perhaps through conversion from mutual to stock organizations. The final area for reform discussed by

⁵⁴ *Agenda for Reform: A report on deposit insurance to the Congress from the Federal Home Loan Bank Board* (Federal Home Loan Bank Board, March, 1983) 6.

⁵⁵ *Ibid.*, 6-7, 21.

the Board involved consolidation of the three deposit insurance funds (FDIC, FSLIC, and NCUSIF, National Credit Union Share Insurance Fund) into one organization.⁵⁶

Eight months after the passage of Garn-St. Germain, Pratt and his Bank Board seemed to be acutely aware of the mismatch between expanded powers of depository institutions and the deposit insurance system. Furthermore, they spoke of the serious consequences of such a mismatch. It is difficult to imagine that they were not aware of this problem when they wrote and lobbied for the legislation. Why then, did they not try to pass a more comprehensive law that would have broadened S&L powers, while at the same time adjusting the deposit insurance system? The answer obviously lay in politics. Congress was unlikely to pass such a profound undoing of New Deal banking regulation. However, this issue might shed light on the process by which the Garn-St. Germain bill moved through Congress.

As discussed in chapter 4, the House and Senate versions of the bill differed significantly. The Democratic-dominated House sought only to pass emergency provisions to prevent the collapse of numerous institutions. Though, the House leadership did want to consider long-term changes such as expanded powers for S&Ls and further deregulation of interest rate caps, they wanted to take more time, analyzing these important issues in a separate bill. Once the House leadership chose to separate the bills, they lost support from the Reagan administration. Recall that Donald Regan withdrew his willingness to testify before the House banking committee once the two bills were separated. Why was the bundling of these bills so important to the administration? The Republican-dominated Senate, on the other hand, chose to bundle together the emergency provisions with long-term deregulatory change. In the Senate,

⁵⁶ Ibid, 6-7.

Dick Pratt and the Reagan administration had more power to guide the bill's provisions because Jake Garn, an administration insider and good friend to Dick Pratt, served as chairman of the banking committee. The Senate passed the full bill, went to conference with the House, and saw the inclusion of virtually all the Senate bill's provisions in the final draft. The House was all but forced to accept the conference report because it was voted on during the final hours of the session, under a rule that prohibited separate voting on individual provisions. If the House wanted troubled S&Ls to receive emergency assistance, it had to also agree to radical deregulation of the industry. Many in the House favored some sort of deregulation initiative anyway. However, pushing the bill through in such a hurried manner meant that all the consequences of profound deregulation would not be considered. One of those consequences was the problem with deposit insurance discussed by Pratt and the Bank Board eight months later. Once deregulation became a fate accomplished, Pratt could argue that the situation necessitated privatization and alteration of the deposit insurance system.

This is not to contend that Pratt and the administration planned this process as a means to force a specific change in deposit insurance. However, the bundling of deregulation with emergency provisions, and the timing of the vote, probably made it significantly easier to pass a deregulatory bill. It may also have resulted in a greater degree of deregulation than would have occurred had the bills been considered separately and in a less hurried manner. In a more thoughtful legislative process, skeptics might have brought to light some of the logical consequences of an extreme deregulatory bill and built enough opposition to force a compromise. In the end, if the Reagan administration was trying to bring about risk-based premiums and privatization of deposit

insurance, they did not get what they wanted. Risk-based premiums for deposit insurance were not implemented until 1992, and insurance privatization still has not occurred.

The deregulatory strategy pursued in the 1980s had other repercussions, such as economic downturns in specific localities, and perhaps to the U.S. economy overall. S&Ls encouraged to gamble, lent so much capital to building projects that overbuilding resulted, especially in commercial real estate. The corresponding drop in real estate value hurt local and regional economies. Some have argued that the real estate bubble and burst of the 1980s even contributed to the recession of 1990.⁵⁷

S&L policy of the 1980s also had implications on the regional balance of economic and political power in the late 20th century U.S. Because of the dual system that allowed states to charter savings and loans as well as the federal government, there had always been differences in S&L regulations. These differences led to meaningful variations in S&L liabilities and assets that reflected the specific economic conditions in individual states. For example, as discussed in chapter 2, California S&Ls did business differently from the rest of the industry because of the huge population influx following World War II, and the corresponding excessive demand for housing. Texas S&Ls also operated differently from the rest of the nation because of the unique demands and outcomes of its oil-based economy. Likewise, the enormous, growth and development of the Sunbelt states, based largely on post World War II federal defense spending, caused the region's S&Ls to fare differently from those in the rest of the nation.

⁵⁷ R. Dan Brumbaugh, *The Collapse of Federally Insured Depositories*, 10-11, James K. Glassman, "The Great Banks Robbery in Robert Emmet Long, editor, *Banking Scandals: The S&Ls and BCCI*, (The H.W. Wilson Company, 1993) 32.

For example, Texas and California had always regulated their savings and loans rather liberally. Long before the deregulation of the 1980s, Texas S&Ls could invest in commercial real estate and consumer loans. California too deregulated before the rest of the industry. Both states were among the first to allow stock ownership of thrift institutions, and California was the first state in which both state and federal institutions could write adjustable rate mortgages. Thus, the deregulation of the 1980s, to a large degree, extended the policies of California and Texas to the rest of the nation.⁵⁸

After passage of the Garn-St. Germain Act, many states followed suit by deregulating their state-chartered institutions. This was done out of fear that institutions desiring expanded asset powers would convert from state to federal charters. Arizona, Texas, Florida, Ohio, and Maryland were among the states that reacted to federal deregulation with their own state deregulation. However, no state proved quite as proactive as California. State law in California permitted state corporations to give political contributions to candidates running for state office only, not federal office. Thus, the threat of charter conversion carried more weight in that state. When some of California's S&Ls began to convert to federal charters during the late 1970s, the state's legislature responded with the Nolan Act. Passed in the fall of 1982, this law gave S&Ls the power to invest in any assets they pleased. When Congress passed the Garn-St. Germain Act, state institutions had no incentive to change charters. The dynamics of the dual charter system created a strange kind of competition between the federal government and the states as to who could offer more lenient regulation.⁵⁹

⁵⁸ Norman Strunk and Fred Case, 46, 56-66.

⁵⁹ Norman Strunk and Fred Case, 58-59; Martin Lowy, 52-3.

A high percentage of the so-called, “high-flying” S&Ls, those institutions that grew at an amazing rate and gambled in speculative ventures, were located in the Southwest, both because of the more lenient state regulations and because of opportunities offered by the enormous growth of that region. Among the famous ones were Silverado, a Denver association with Neil Bush serving on its Board, Empire in Texas, Charles Keating’s Lincoln Savings and Loan in Arizona, and American Diversified in California. For a while, the fast-growing high flyers looked like models of excellence. For example, Texas institutions, which had diversified their investments before others, looked much more profitable than other S&Ls during the hard years of 1979-1982. However, these practices eventually led to the disaster of the late 1980s and Texas, which appeared to have healthy institutions earlier in the decade, led the nation in insolvencies by 1988.⁶⁰

Just as regulations varied by state, so did the degree of financial stress experienced by S&Ls and the cost of resolving troubled institutions. In 1987, chief Bank Board economist James Barth, commented that when it came to losses, “Clearly, the many are being pulled by the few.” In 1987, 20 institutions created a loss to FSLIC of \$2.1 billion. These institutions were all located in Texas and other southwestern states. They were responsible for 67% of the industry’s losses that year.⁶¹ Barth later calculated that 50% of the cost for the total bailout was attributable to institutions in Texas, while California, Florida, and Illinois were together responsible for 25%.⁶² Another analysis of bailout costs by economist Edward Hill, estimated that the bailout would cost a total of \$150 billion plus interest. Thirteen states, located mainly in the south and southwest,

⁶⁰ M. Manfred Fabrituis and William Borges, 114-120.

⁶¹ Ibid., 144.

⁶² James Barth, 33.

emerged net winners, he argued, while 37 states became net losers. While Connecticut would lose \$882 per capita on the bailout, Texas would gain \$3510 per capita, he explained.⁶³ Another study conducted by The Northeast-Midwest Congressional Coalition, analyzed costs in a slightly different way. The 1988 study compared tax rates to responsibility for FSLIC losses. Texas paid 6.6% of the nation's tax bill, yet accounted for 65% of the S&L bailout costs that year, the study revealed. On the other hand, the 18 states of the northeast and Midwest paid 47% of the country's taxes and incurred only 10% of FSLIC costs that year. The study's authors argued that the S&L bailout represented a transfer of wealth from one region to another.⁶⁴ In an entertaining analogy, they compared the S&L debacle with going to a fancy restaurant with your Texas cousin. While you order conservatively, he spends extravagantly, and then comes up short when the bill arrives. Everyone else, of course, gets "stuck with the tab."⁶⁵ In 1993, another calculation revealed that half of the failed assets held by the Resolution Trust Corporation (RTC) were located in Texas and Oklahoma.⁶⁶

The movement of billions of dollars from the rest of the country to the southwest, in order to rescue or liquidate failed institutions, transferred income and wealth to the Sunbelt. Journalist Martin Mayer, disagrees, calling this assertion "nonsense." States receiving large bailout funds did not benefit, he argues. They suffered from problems such as real estate market collapse.⁶⁷ He is, in fact, correct. However, if one looks beyond the late 1980s and into the future, the Southwest region clearly reaped great

⁶³ Lenny Glynn, "Who Really Made the S&L Mess?" in Long, 19.

⁶⁴ Keith Laughlin, Mary Weaver, Bob Kelley, *Stuck With the Tab: The Regional Implications of the Savings and Loan Bail-Out* (Northeast-Midwest Institute The Center for Regional Policy, 1989) 1.

⁶⁵ Ibid.

⁶⁶ Lenny Glynn in Long, 11.

⁶⁷ Martin Mayer, 311.

rewards from the fate of the S&Ls in its states. In an effort to grow quickly and gamble for resurrection, many institutions in the southwest offered outrageously high interest rates and attracted capital from states across the nation. In essence, as Paul Zane Pilzer has stated, the rest of the country loaned money to the Sunbelt states.⁶⁸ Institutions invested this money in all kinds of projects within their region, from malls to windmill farms. Executives at these associations paid themselves outrageously high salaries. They spent much of this money in the regional economy. The resulting overbuilding of commercial and residential real estate did indeed create a real estate bubble that eventually burst painfully. This, combined with terrible management and fraud, took down many of the region's thrift institutions. However, bailout money paid the tab for the problem and the effects of the ensuing real estate slump, though serious in the short term, did not last forever. The positive effect of the infusion of billions of dollars of capital into the region would far outlast the negative effects. As Edward Hill argued, "A more relevant point is that the 'distressed' office buildings, malls, and condos the feds are now trying to sell in the 'winning' Sunbelt states will serve for years to come as lures for companies in other regions to relocate in what amounts to financial free-fire zones."⁶⁹ The argument that a region benefited from growth so rapid that it resulted in a real-estate bubble that eventually burst is a contentious one. However, it does seem to hold true for the Sunbelt in the late 1980s. For example, Texas, which experienced severe economic problems in the late 1980s, including collapse of its real estate market, bounced back fairly quickly. The 1989-2001 job growth rate in TX (2.7%) exceeded that of the U.S. as a whole (1.5%) as did the population growth rate. (2.0% for TX, 1.2% for the U.S. as a

⁶⁸ Paul Zane Pilzer, 82-83.

⁶⁹ Lenny Glyn, 19.

whole). This supports Hill's argument that the Sunbelt emerged from the S&L disaster as an attractive location for businesses.⁷⁰

In addition, the billions of dollars that moved into the Sunbelt from the end of World War II through the end of the 1980s resulted in millions of dollars in political contributions just as the New Right began its ascent to political dominance. Savings and loans indirectly contributed to the ascent through political contributions and regional economic stimulation. Eastern investors, who enthusiastically sent their funds to high-flying southwestern S&Ls, and profited enormously from above-market interest rates, may have unknowingly financed the very region and political party against which they competed.⁷¹

It is no coincidence that the S&L crisis was particularly severe in the home states of former Presidents Reagan, Bush, Sr., and Bush, Jr. In the field of banking, economics and politics are intimately intertwined; banking is, by definition, political. Political scientist, Susan Hoffman, perhaps puts this best:

What the textbooks do not convey, indeed what they obscure is how political the banking process is. In their central process of taking in deposits and making loans, these institutions create and allocate money. They decide where credit will flow throughout society and thus what human initiatives will flourish and which will wither. People, ventures, regions, win and lose.⁷²

⁷⁰ Robert W. Gilmore, "The Face of Texas: Jobs, People, Business, Change" October 2005, Federal Reserve Bank of Dallas http://www.dallasfed.org/research/pubs/fotexas/fotexas_gilmer.html accessed 6/15/09.

⁷¹ In her case study of Orange County, California, Lisa McGirr studied the flourishing of conservative grass roots political activism that occurred beginning in the 1960s. Deregulatory sentiment was strong there, she explains. Celebration of the free market came easy in Orange County, where the economy thrived from government military and defense spending. Conservative cultures grew rapidly in other Sunbelt areas, she argues, that "shared an older regional identity defining itself against northeastern power." These areas also tended to have wealthy and skilled populations, and economies benefiting from defense and military spending. See Lisa McGirr, *Suburban Warriors: The Origins of the New American Right* (Princeton University Press, 2001), quote from page 14.

⁷² Susan Hoffman, *Politics and Banking: Ideas, Public Policy, and the Creation of Financial Institutions* (The Johns Hopkins University Press, Baltimore, 2001) 2.

Political ideology about the relationship between government and business played a central role in the S&L story. Lenny Glynn emphasizes the need to put the S&L collapse into the context of “Sunbelt ideology,” which he defines as “pseudo-laissez-faire, shamelessly combining a drive to get government ‘off the backs’ of business with a huge appetite for government spending and guarantees... It’s party-time ideology, bereft of accountability.”⁷³ Sunbelt ideology originated in the Goldwater campaign, Glynn explains, as a purely conservative ideology. However, by the time Reagan became president, it had been transformed into a program of retaining New Deal programs officially, while doing away with New Deal restrictions through deregulation. The goal was to provide business with a “‘free market’ with risks guaranteed or underwritten by the state.”⁷⁴ That is just what the thrift deregulatory program achieved. It was appropriate, Glynn argues, that the worst of the crisis occurred in the Southwest, given its love-hate relationship with the federal government. The region’s political rhetoric claimed a preference for smaller government, yet, it also clamored for federal spending.⁷⁵ Thrift deregulation became yet another case of heads private individuals win, tails the federal government and the taxpayers lose.

The famous story of Charles Keating, owner of Lincoln Savings and Loan, illustrates almost all of these problems. Charles Keating bought Lincoln Savings and Loan in 1983, in a deal that never should have been approved by regulators. Keating was one of the many land developers attracted to the industry because of the ease with which an S&L owner could raise and invest cash after the deregulatory campaign of 1982. Like many of the new S&L owners and executives, Keating had a past. In 1979, in connection

⁷³ Lenny Glynn in Long, 12.

⁷⁴ Ibid.

⁷⁵ Ibid.

with his role as officer of American Financial Corporation, the SEC charged Keating and his law firm with granting improper loans to insiders and failure to report a pattern of loans to purchasers of assets. The Lincoln purchase was approved nonetheless. Keating promised regulators at the Federal Home Loan Bank Board that he would keep Lincoln's top management staff intact and that he would continue the S&L's tradition of writing mortgages in poorly served black and Hispanic neighborhoods. However, once the purchase was approved and complete, Keating immediately broke both these promises. He then began an enormous expansion of the institution, collecting a vast sum of brokered deposits by paying extremely high rates of return. He invested these funds, not in mortgages, but in risky ventures, including his own dabbling in hotels and planned communities. When many of these investments proved unprofitable, Keating used various tricks to beef up his income figures, including trading bad loans and properties with other associations in a scheme commonly referred to as a "daisy chain," and making loans to "straw borrowers," people who never intended to repay the loans.⁷⁶

Keating was a generous contributor to elected officials of both parties and when Lincoln came under investigation by the San Francisco Home Loan Bank Board, he called in his political favors, asking regulators and senators to help him stop the investigation. In a story that became infamous, five senators, Alan Cranston (D,CA), Dennis Deconcini (D,AZ), John Glenn (D,OH), John McCain (R,AZ), and Donald Riegle (D,MI) worked on his behalf. Donald Riegle asked Federal Home Loan Bank Board Chairman Ed Gray to attend a meeting in Senator DeConcini's office without any staff accompanying him. At the meeting, the other four senators accused regulators of

⁷⁶ Martin Mayer, 165-186. Howard Rudnitsky, "Good Timing, Charlie," in Robert Emmet Long, editor, *Banking Scandals: The S&Ls and BCCI* (The H.W. Wilson Company, 1993) 36. Also see Michael Binstein and Charles Bowden, *Trust Me: Charles Keating and the Missing Billions* (Random House, 1993).

harassing Charles Keating and asked Gray to suspend the investigation. Keating had contributed generously to the campaigns of all five senators. Eventually Lincoln Savings and Loan was resolved by regulators; Charles Keating served 4 ½ years in prison for fraud, racketeering, and conspiracy before an appeals court overturned his conviction; and a Senate Ethics Committee determined that McCain and Glenn had shown poor judgment, and Cranston, Deconcini, and Riegle had improperly interfered with regulators. The committee officially reprimanded only Alan Cranston.⁷⁷

The Lincoln case is an extreme example, but it embodied many trends and practices that occurred in other thrifts: the use of brokered funds to create rapid growth, creative and even illegal accounting practices, and perhaps most important, the implication of highly respected professionals. Lincoln's business practices relied on the support of appraisers, accountants, lawyers, regulators, senators, and even soon-to-be Federal Reserve Chairman Alan Greenspan, who wrote a letter to the Federal Home Loan Bank Board on Keating's behalf, arguing that Lincoln should be exempt from the board's 10% limit on direct investments.⁷⁸ Furthermore, Keating gave generously to the campaigns of Congressmen in both parties with the single goal of buying political influence. This is most obvious in the case of Senator Alan Cranston. Keating donated \$850,000 to Cranston's campaign, mainly through voter registration groups. However, as political scientist, Dennis Thompson has argued, the policy views of Keating and Cranston could not have been more dissimilar, "an arch conservative Arizona businessman devoted to the free market and opposed to pornography and abortion teamed up with one of the leading liberals in the Senate, a former candidate for president who

⁷⁷ Ibid., 187-203.

⁷⁸ Ibid., 324-325.

had called for a nuclear freeze and higher social spending.”⁷⁹ The donations were clearly meant to buy the kind of help that Cranston provided when Lincoln Savings and Loan came under investigation.

There is no shortage of blame to go around in the S&L story. The New Deal restructuring of banking created a flawed system that was too rigid to adjust for its flaws as changing conditions made them obvious and problematic. Thrifts are not to blame for the trouble they got into while doing exactly what this system asked of them. Once inflation and rising interest rates made the regulatory flaws obvious, it took entirely too long to solve the problem. Interest groups representing S&Ls, banks, builders, and realtors spent years and millions of dollars protecting the status quo because they feared that change would hurt them. Long after multiple studies had identified the problems; long after anyone with an elementary understanding of the industry saw the crisis coming; long after thrifts themselves knew that change was inevitable; these groups continued to lobby against viable solutions. The eventual result was a solution that cost everyone in the U.S. exponentially more than a timely resolution would have cost.

The efforts of the Carter administration in passing DIDMCA were admirable. Had the law been passed ten years earlier, it might have worked. As it was, it deregulated the liability side more quickly than the asset side. In the high interest rate environment of the early 1980s, this perhaps made the industry’s problems a bit worse, at least until rates dropped. However, it provided for a future in which thrifts could compete for deposits with unregulated investment options such as money market mutual funds. It also permitted some degree of asset diversification. While it was no panacea, it was a sincere,

⁷⁹ Dennis F. Thompson, “Mediated Corruption: The Case of the Keating Five” *The American Political Science Review*, Vol. 87, No. 2 (Jun., 1993) 376.

feasible, and sensible beginning, especially considering the difficulty involved in passing legislation that affected so many influential interest groups.

It is more difficult to find kind words for the Garn-St. Germain Act and the FHLBB's deregulatory program of the early 1980s. The strategy was created by a combination of political pragmatism, ideological fervor, and outright greed. Reagan's need to please his broad constituency limited the approaches his administration was willing to take in solving the S&L problem. Also, his administration's ardent neo-liberal belief that "government is the problem," and their ability to convince most of America to have faith in what they called the free market, sent them down a wild path of extreme deregulation. However, as David Stockman found out the hard way, the Reagan administration was not truly devoted to free market outcomes. They adhered precisely to Lenny Glynn's Sunbelt ideology. They did not do away with, or even significantly cut most New Deal programs. In the case of savings and loans, they simply deregulated, allowing and even inviting constituents to gamble and commit fraud, repaying their debt to generous campaign contributors. Thus, savings and loan deregulation delayed and disguised the problem, while benefiting many of Reagan's Sunbelt supporters, who used the perverse incentives inherent in deregulation as a means for becoming rich. Reagan succeeded in his strategy, managing to leave office without having to formulate a genuine solution to the S&L problem. He left that unpleasant task for his successor, George Bush. It would take a \$50 billion bailout to clean up the mess. With interest and additional costs, economists estimate the final bill anywhere from \$150-\$300 billion.

This era represented the beginning of a strong faith in deregulation and a desire to let the marketplace produce its outcomes unfettered. The Reagan administration

displayed a reverence for the market and an embracing of greed not present in America's political dialogue since the Great Depression. Though the S&L disaster shook that faith a bit, it did not break it. The deregulatory impulse continued, across Republican and Democratic administrations alike. The prosperous 1990s only reinforced the sentiment. In 1994, the Riegle-Neal Act allowed for the chartering of multi-state bank holding companies and authorized full interstate bank branching for all states not choosing to override the legislation. By 1999, Democratic President Bill Clinton gave deregulation his official blessing, signing the Gramm-Leach Bliley Act. This act undid Glass-Steagall's separation of commercial and investment banking, allowing the creation of financial service conglomerates, institutions that would become "too big to fail."⁸⁰

In light of the financial collapse of the fall of 2008, a disaster costing \$150-\$300 billion does not sound as large as it once did. However, the significance of the savings and loan story goes far beyond its cost to taxpayers. It calls into question the ability of American Democracy to effectively legislate, at least with regard to economic issues. It was part of and reflected a new outlook that normalized speculation, greed, and gambling. The savings and loan debacle, which took place before the backdrop of a restructuring U.S. economy, was molded by a series of changes that made the U.S. economy look more like a casino than like a global industrial power. As the mass production, mass consumption postwar economy crumbled under the weight of overproduction in the early 1970s, U.S. capitalism might have collapsed as Karl Marx had predicted. However, the system proved resilient. Capitalists remade it, turning away from productive capacity and towards a complex game of speculative risk, a game stacked in favor of the wealthiest Americans. Deregulation became part of that game as

⁸⁰ Donald D. Hester, "U.S. Banking in the Last Fifty Years," 19-23.

it allowed capitalists to exploit new investment opportunities the way that they exploited workers of the past. Today, we are just beginning to discover where this road will take us.

BIBLIOGRAPHY

- '81 *Savings and Loan Sourcebook: Formerly Savings and Loan Fact Book*. Chicago: United States League of Savings Associations, 1981.
- '82 *Savings and Loan Sourcebook*. Chicago: United States League of Savings Associations, 1982.
- '83 *Savings and Loan Sourcebook*. Chicago: United States League of Savings Associations, 1983.
- 1965 *Savings and Loan Fact Book*. Chicago: United States League of Savings Associations, 1965.
- 1966 *Savings and Loan Fact Book*. Chicago: United States League of Savings Associations, 1966.
- 1984 *Savings Institutions Sourcebook*. Chicago: United States League of Savings Associations, 1984.
- 1985 *Savings Institutions Sourcebook*. Chicago: United States League of Savings Associations, 1985.
- 1987 *Savings Institutions Sourcebook*. Chicago: United States League of Savings Associations, 1987.
- Adams, James Ring. *The Big Fix: Inside the S&L Scandal, How an Unholy Alliance of Politics and Money Destroyed America's Banking System*. New York: John Wiley & Sons, 1990.
- Aliber, Robert Z. "The Commission on Money and Credit, Ten Years Later," *Journal of Money, Credit and Banking*, Vol. 4, No. 4. (Nov., 1972) 915-929.
- Allen, Paul R. and William J. Wilhelm. "The Impact of the 1980 Depository Institutions Deregulation and Monetary Control Act on Market Value and Risk: Evidence from the Capital Markets," *Journal of Money, Credit and Banking*, Vol. 20, No.3, Part 1, (Aug., 1988) 364-380.
- Balderston, Frederick E. *Thriffs in Crisis: Structural Transformation of the Savings and Loan Industry*. Cambridge, MA: Ballinger Publishing Company, 1985.
- Barth, James R. *The Great Savings and Loan Debacle*. Washington D.C.: The AEI Press, 1991.

- Beatty, Jack. *Colossus: How the Corporation Changed America*. New York: Broadway Books, 2001.
- Bentson, George J. "Discussion of the Hunt Commission Report: Comment" *Journal of Money, Credit, and Banking* Vol. 4, No. 4 (November, 1972) 985-989.
- _____ and George G. Kaufman. *Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options*. New York: New York University, 1988.
- Binstein, Michael and Charles Bowden. *Trust Me: Charles Keating and the Missing Billions*. New York: Random House, 1993.
- Biederman, Kenneth R. and John A. Tuccillo. *Taxation and Regulation of the Savings and Loan Industry*. Lexington, MA: Lexington Books, 1976.
- Bird, Anat. *Can S&Ls Survive? The Emerging Recovery, Restructuring & Repositioning of America's S&Ls*. Chicago: Bankers Publishing Company and Probus Publishing Company, 1993.
- Biven, W. Carl. *Jimmy Carter's Economy: Policy in an Age of Limits*. Chapel Hill: University of North Carolina Press, 2002.
- Black, William K. *The Best Way to Rob a Bank is to Own One*. Austin: The University of Texas Press, 2005.
- Blackford, Mansel G. and Austin Kerr. *Business Enterprise in American History*. Boston: Houghton Mifflin Company, 1990.
- Bluestone, Barry and Bennett Harrison. *The Deindustrialization of America: Plant Closings, Community Abandonment, and the Dismantling of Basic Industry*. New York: Basic Books, 1982.
- Bodenhorn, Howard. *A History of Banking in Antebellum America: Financial Markets and Economic Development in an Era of Nation Building*. New York: Cambridge University Press, 2000.
- Bodfish, Morton. *History of Building and Loan in the United States*. Chicago: United States Building and Loan League, 1932.
- Boskin, Michael J. *Reagan and the Economy: The Successes, Failures, and Unfinished Agenda*. San Francisco: ICS Press, 1989.
- Bowman, Scott R. *The Modern Corporation and American Political Thought: Law, Power and Ideology*. University Park: Pennsylvania State University Press, 1996.

- Braverman, Harry. *Labor and Monopoly Capital: The Degradation of Work in the Twentieth Century*. New York: Monthly Review Press, 1974.
- Brinkley, Alan. *The End of Reform: New Deal Liberalism in Recession and War*. New York: Alfred A. Knopf, 1995.
- Brumbaugh, R. Dan, Jr. *The Collapse of Federally Insured Depositories: The Savings and Loans as Precursor*. New York: Garland Publishing, Inc., 1993.
- _____. *Thriffs Under Siege: Restoring Order to American Banking*. Cambridge: Ballinger Publishing Company, 1988.
- Brunner, Karl. "The Report of the Commission on Money and Credit" *The Journal of Political Economy*, Vol. 69, No. 6 (Dec., 1961) 605-607.
- Calavita, Kitty, Henry N. Pontell and Robert H. Tillman. *Big Money Crime: Fraud and Politics in the Savings and Loan Crisis*. Berkeley: University of California Press, 1997.
- Calomiris, Charles W. *U.S. Bank Deregulation in Historical Perspective*. Cambridge, U.K., New York: Cambridge University Press, 2000.
- Campagna, Anthony S. *The Economy in the Reagan Years: The Economic Consequences of the Reagan Administrations*. Westport: Greenwood Press, 1994.
- Cargill, Thomas F. and Gillian G. Garcia. *Financial Deregulation and Monetary Control: Historical Perspective and Impact of the 1980 Act*. Stanford: Hoover Institution Press, 1982.
- Carron, Andrew S. *The Plight of the Thrift Institutions*. Washington D.C.: The Brookings Institution, 1982.
- _____. *The Rescue of the Thrift Industry*. Washinton D.C.: The Brookings Institution, 1983.
- Carter, Jimmy. *Keeping the Faith*. New York: Bantam Books, 1982.
- Cashin, Jack W. *History of Savings and Loan in Texas*. Austin: College of Business Administration The University of Texas, 1956.
- Cavanaugh, Francis. *The Truth About the National Debt: Five Myths and One Reality*. Boston: Harvard Business School Press, 1996.
- Chandler, Alfred D. *Strategy and Structure: Chapters in the History of Industrial Enterprise*. Cambridge: M.I.T. Press, 1962.

-
- . *The Visible Hand: The Managerial Revolution in American Business*. Cambridge: The Belknap Press, 1977.
- Chandler, Lester V. "Regulating the Regulators: A Review of the FINE Regulatory Reforms," *Journal of Money, Credit and Banking*, Vol. 9, No. 4 (Nov., 1977) 619-635.
- Collins, Robert M. *More: The Politics of Economic Growth in Postwar America*. Oxford: Oxford University Press, 2000.
- Comett, Marcia Milton and Hassan Tehranian. "An Examination of the Impact of the Garn-St. Germain Depository Institutions Act of 1982 on Commercial Banks and Savings and Loans," *The Journal of Finance*, Vol. 45, No. 1 (Mar., 1990), 95-111.
- Conway, Lawrence V. *Savings and Loan Principles*. Chicago: American Savings and Loan Institute Press, 1964.
- Cottrell, Allin F., Michael S. Lawlor and John H. Wood, editors. *The Causes and Costs of Depository Institution Failures*. Boston: Kluwer Academic, 1995.
- Cowie, Jefferson. *Capital Moves: RCA's Seventy-Year Quest for Cheap Labor*. Ithaca: Cornell University Press, 1999.
- Davies, Glyn. *A History of Money: From Ancient Times to the Present Day*. Cardiff: University of Wales Press, 2002.
- Davis, Mike. *Prisoners of the American Dream: Politics and Economy in the History of the U.S. Working Class*. London: Verso, 1986.
- Day, Kathleen. *S&L Hell: The People and the Politics Behind the \$1 Trillion Savings and Loan Scandal*. New York: W.W. Norton & Company, 1993.
- Doti, Lynn Pierson and Larry Schweikart. "Financing the Postwar Housing Boom in Phoenix and Los Angeles, 1945-1960," *Pacific Historical Review* (1989) 173-194.
- Eichler, Ned. *The Thrift Debacle*. Berkeley: The University of California Press, 1989.
- England, Catherine and Thomas Huertas. *The Financial Services Revolution: Policy Directions for the Future*. Boston: Kluwer Academic Publishers, 1988.
- Ewalt, Josephine Hedges. *A Business Reborn: The Savings and Loan Story, 1930-1960*. Chicago: American Savings and Loan Institute Press, 1962.
- Fabritius, M. Manfred and William Borges. *Savings the Savings and Loan: The U.S. Thrift Industry and the Texas Experience, 1950-1988*. New York: Praeger, 1989.

Ferguson, Thomas. *Golden Rule: The Investment Theory of Party Competition and the Logic of Money-Driven Political Systems*. Chicago: University of Chicago Press, 1995.

Ferguson, Thomas and Joel Rogers. *The Hidden Election: Politics and Economics in the 1980 Presidential Campaign*. New York: Pantheon Books, 1981.

_____, editors. *The Political Economy: Readings in the Politics and Economics of American Public Policy*. New York: M.E. Sharpe, Inc, 1984.

_____. *Right Turn: The Decline of the Democrats and the Future of American Politics*. New York: Hill and Wang, 1986.

Finkelstein, Joseph. *The American Economy: From the Great Crash to the Third Industrial Revolution*. Wheeling, IL: Harlan Davidson, Inc., 1992.

Friend, Irwin, study director. *Study of the Savings and Loan Industry*. Washington D.C.: U.S. Government Printing Office, 1969.

Gilmore, Robert W. "The Face of Texas: Jobs, People, Business, Change," October 2005, Federal Reserve Bank of Dallas
http://www.dallasfed.org/research/pubs/fotexas/fotexas_gilmer.html.

Gordon, David M., Richard Edwards, and Michael Reich. *Segmented Work, Divided Workers: The Historical Transformation of Labor in the United States*. New York: Cambridge University Press, 1982.

Hammond Bray. *Banks and Politics in America from the Revolution to the Civil War*. Princeton: Princeton University Press, 1957.

_____. "Jackson, Biddle, and the Bank of the United States," *The Journal of Economic History*, Vol. 7, No. 1 (May, 1947) 1-23.

Harvey, David. *A Brief History of Neo-Liberalism*. Oxford: Oxford University Press, 2005.

Harvey, David. *The Condition of Postmodernity: An Inquiry into the Origins of Cultural Change*. Oxford: Bais Blackwell, 1990.

Hayashi, Fumiko, Richard Sullivan, and Stuart E. Weiner, "A Guide to the ATM and Debit Card Industry," Federal Reserve Bank of Kansas City,
http://www.ffiec.gov/ffiecinfobase/resources/retail/frb-guide%20to%20the_atm_debit_card_ind.pdf.

- Heilbroner, Robert L. and Aaron Singer. *The Economic Transformation of America: 1600 to the Present*. Wadsworth, 1999.
- Hester, Donald D. "U.S. Banking in the Last Fifty Years: Growth and Adaptation," <http://www.ssc.wisc.edu/econ/archive/wp2002-19>.
- Hixson, William F. *Triumph of the Bankers*. New York: Praeger, 1993.
- Hoffman, Susan. *Politics and Banking: Ideas, Public Policy, and the Creation of Financial Institutions*. Baltimore: Johns Hopkins University Press, 2001.
- Humphrey, David B. and Lawrence B. Pulley. "Banks' Responses to Deregulation: Profits, Technology, and Efficiency," *Journal of Money, Credit and Banking*, Vol. 29, No. 1 (Feb., 1997) 73-93.
- Hurst, James Willard. *Law and the Conditions of Freedom in the Nineteenth-Century United States*. Madison: University of Wisconsin Press, 1956.
- Jones, Charles O. "Carter and Congress: From the Outside In" *British Journal of Political Science* Vol. 15, No. 3 (July 1985) 269-298.
- Kane, Edward J. *The S&L Insurance Mess: How Did it Happen?* Washington D.C.: The Urban Institute Press, 1989.
- Katznelson, Ira. *When Affirmative Action Was White: An Untold History of Racial Inequality in Twentieth-Century America*. New York: W.W. Norton & Company, 2005.
- Kendall, Leon T. *The Savings and Loan Business: Its Purposes, Functions, and Economic Justification*. Englewood Cliffs: Prentice-Hall, Inc., 1962.
- Klein, Naomi. *The Shock Doctrine: The Rise of Disaster Capitalism*. New York: Henry Holt and Company, 2007.
- Laughlin, Keith, Mary Weaver, Bob Kelley. , *Stuck With the Tab: The Regional Implications of the Savings and Loan Bail-Out*. Washington D.C.: Northeast-Midwest Institute The Center for Regional Policy, 1989.
- Leuchtenburg, William E. *Franklin D. Roosevelt and the New Deal 1932-1940*. New York: Harper & Row, 1963.
- Lewis, Michael. *Liar's Poker: Rising Through the Wreckage on Wall Street*. New York: Norton, 1989.
- Long, Robert Emmet, editor. *Banking Scandals: The S&Ls and BCCI*. New York: The H.W. Wilson Company, 1993.

Lowy, Martin. *High Rollers: Inside the Savings and Loan Debacle*. New York: Praeger, 1991.

Mason, David. *From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995*. Cambridge: Cambridge University Press, 2004.

Mayer, Martin. *The Greatest Ever Bank Robbery: The Collapse of the Savings and Loan Industry*. New York: Charles Scribner's Sons, 1990.

McGirr, Lisa. *Suburban Warriors: The Origins of the New American Right*. Princeton: Princeton University Press, 2001.

Meiners, Roger E. and Bruce Yandle, editors. *Regulation and the Reagan Era: Politics, Bureaucracy and the Public Interest*. New York: Holmes & Meier, 1989.

Montgomery, David. *The Fall of the House of Labor: The Workplace, the State, and American Labor Activism*. New York: Cambridge University Press, 1987.

Morgan, Iwan. , "Jimmy Carter, Bill Clinton, and the New Democratic Economics," *The Historical Journal*, 47, 4 (2004) 1015-1039.

Mortimer, Harold E., Chairman. *The Depository Institutions Act of 1982*. Practicing Law Institute, 1983.

Murdock, Eric J. "The Due-on-Sale Controversy: Beneficial Effects of the Garn-St. Germain Depository Institution Act of 1982" *Duke Law Journal*, Vol. 1984, No. 1 (Feb., 1984) 121-140.

New Sources of Capital for the Savings and Loan Industry. San Francisco: Federal Home Loan Bank of San Francisco, 1979.

Office of the Comptroller of the Currency, "About the OCC: James J. Saxon, Comptroller of the Currency, 1961-1966," <http://www.occ.treas.gov/saxon.htm>.

Pescheck, Joseph G. "The Rehabilitation of Jimmy Carter and the Limits of Mainstream Analysis" *Polity* Vol. 23, No. 1 (Autumn 1990) 139-152.

Pierce, James L. "The FINE Study," *Journal of Money, Credit and Banking* Vol. 9, No. 4. (Nov., 1977) 605-618.

Pilzer, Paul Zane with Robert Deitz. *Other People's Money: The Inside Story of the S&L Mess*. New York: Simon and Schuster, 1989.

- Pizzo, Stephen, Mary Fricker and Paul Muolo. *Inside Job: The Looting of America's Savings and Loans*. New York: McGraw Hill, 1989.
- Porter, Roger B. "Advising the President," *PS*, Vol. 19, No. 4 (Autumn, 1986), 867-869.
- Pratt, Richard T. *Agenda for Reform: A Report on Deposit Insurance to the Congress from the Federal Home Loan Bank Board*. Washington D.C.: Federal Home Loan Bank Board, 1983.
- Robinson, Roland I. "The Hunt Commission Report: A Search for Politically Feasible Solutions to the Problems of Financial Structure" *The Journal of Finance* Vol 27, No. 4 (September 1972) 765-777.
- Rom, Mark Carl. *Public Spirit in the Thrift Tragedy*. Pittsburgh: University of Pittsburgh Press, 1996.
- Russell, Horace. *Savings and Loan Associations*. New York: Matthew Bender & Company, 1960.
- Schulman, Bruce J. *From Cotton Belt To Sunbelt: Federal Policy, Economic Development, and the Transformation of the South, 1938-1980*. Oxford: Oxford University Press, 1991.
- Seidman, L. William, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*. New York: Times Books, 1993.
- Sinclair, Barbara. "Agenda Control and Policy Success: Ronald Reagan and the 97th House," *Legislative Studies Quarterly*, X, 3 (August 1985) 291-314.
- Sklar, Martin J. *The Corporate Reconstruction of American Capitalism, 1890-1916: The Market, Law, and Politics*. Cambridge: Cambridge University Press, 1988.
- Snowden, Kenneth A. "Building and Loan Associations in the U.S. 1880-1893: The Origins of Localization in the Residential Mortgage Market," *Research in Economics* 51 (1997) 227-250.
- Sobel, Robert. *The Great Boom 1950-2000: How a Generation of Americans Created the World's Most Prosperous Society*. New York: Truman Tally Books, 2000.
- Spellman, Lewis J. *The Depository Firm and Industry: Theory, History, and Regulation*. New York: Academic Press, 1982.
- Sprague, Irvine H. *Bailout: An Insider's Account of Bank Failures and Rescues*. New York: Basic Books, 1986.

- Stockman, David. *The Triumph of Politics: How the Reagan Revolution Failed*. New York: Harper & Rowe, 1986.
- Strunk, Norman and Fred Case. *Where Deregulation Went Wrong: A Look at the Causes Behind Savings and Loan Failures in the 1980s*. Chicago: United States League of Savings Institutions, 1988.
- Sundquist, James L. "Jimmy Carter as Public Administrator: An Appraisal at Midterm" *Public Administration Review*, Vol. 39, No. 1 (Jan. - Feb., 1979) 3-11.
- Talley, Pat L. *The Savings and Loan Crisis: An Annotated Bibliography*. Westport: Greenwood Press, 1993.
- Taylor, George Rogers. *The Transportation Revolution 1815-1860*. New York: Rinehart, 1951.
- Theobald, A.D. *Forty Five Years on the Up Escalator*. Privately published, 1979.
- Thomas, Norman C. "The Carter Administration Memoirs: A Review Essay" *The Western Political Quarterly*, Vol 29, No. 2, (June, 1986) 348-360.
- Timberlake, Richard H., Jr. "Legislative Construction of the Monetary Control Act of 1980," *The American Economic Review*, Vol. 75, No. 2, Papers and Proceedings of the Ninety-Seventh Annual Meeting of the American Economic Association. (May, 1985), 97-102.
- Torgerson, Harold W. "Developments in Savings and Loan Association, 1945-53," *The Journal of Finance*, Vol. 9, No. 3 (September, 1954) 283-297.
- Vartanian, Thomas P. and John D. Hawke, Jr. *The New Synergy Between Thrifts and Commercial Banks*. New York: Law & Business, Inc., 1983.
- Vatter, Harold G. and John F. Walker, editors. *History of the U.S. Economy Since World War II*. Armonk, NY: M.E. Sharpe, 1996.
- Waldman, Michael. *Who Robbed America? A Citizens Guide to the Savings and Loan Scandal*. New York: Random House, 1990.
- Weatherford, Jack. *The History of Money: From Sandstone to Cyberspace*. New York: Crown Publishers, 1997.
- White, Eugene Nelson. *The Regulation and Reform of the American Banking System, 1900-1929*. Princeton: Princeton University Press, 1983.
- White, Lawrence J. *The S&L Debacle: Public Policy Lessons for bank and Thrift Regulation*. New York: Oxford University Press, 1991.

Wilentz, Sean. *Chants Democratic: New York City and the Rise of the American Working Class, 1788-1850*. New York: Oxford University Press, 1984.

Wilmsen, Steven K. *Silverade: Neil Bush and the Savings & Loan Scandal*. Washington D.C.: National Press Books, 1991.

Woerhide, Walter J. *The Savings and Loan Industry: Current Problems and Possible Solutions*. Westport: Quorum Books, 1984.

Newspapers:

The New York Times

The Washington Post

Websites:

Lexis Nexis <http://www.lexisnexus.com>

The Federal Reserve Bank of Dallas <http://www.dallasfed.org>

The Federal Reserve Bank of Kansas <http://www.ffiec.gov>

The Federal Reserve Bank of New York <http://www.ny.frb.org>

The Federal Reserve Board <http://www.federalreserve.gov>

The Library of Congress, Thomas <http://thomas.loc.gov>

Office of the Comptroller of the Currency <http://www.occ.treas.gov>

Office of Thrift Supervision <http://files.ots.treas.gov>

U.S. Census Bureau <http://www.census.gov/>

Archives:

Carter, Jimmy. Papers. The Jimmy Carter Presidential Library (Atlanta, GA).

U.S. Government Sources:

Carter, Jimmy. "Financial Reform Legislation Message to the Congress Proposing the Legislation" *Weekly Compilation of Presidential Documents* (May 22, 1979) 15928-15930.

Federal Election Commission. *1979-1980 Candidate Index of Supporting Documents*, Frank Annunzio. Printed July 6, 2005.

Reagan, Ronald. "Remarks on signing HR 6267 into law – Garn-St. Germain Depository Institutions Act of 1982" *Weekly Compilation of Presidential Documents*, Volume 18, number 41, (October 15, 1982) 1319-1320.

U.S. Congress. *Congressional Record* 125, 127, 128.

U.S. Congress. House of Representatives. Committee on Lobbying Activities. *Lobbying Activities of United States Savings and Loan League*, hearings, 81st Congress, 2nd session, October 31, 1950.

- U.S. Congress. House of Representatives. Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation, and Insurance. Hearings. *Financial Institutions and the Nation's Economy (FINE) "Discussion Principles"* Hearings 94th Congress First and Second Sessions, 1975.
- U.S. Congress. House of Representatives. Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance. Hearings, *Consumer Financial Services Act of 1977 (NOW Account Legislation)*, 95th Congress, 1st session. September 7, 1977.
- U.S. Congress. House of Representatives. Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation and Insurance. Hearings. *Financial Institutions and the Nation's Economy (FINE) "Discussion Principles"* 94th Congress, 1st and 2nd sessions, Part I, December 2, 1975.
- U.S. Congress. House of Representatives. Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing. *Consumer Financial Services Act of 1977 (NOW Account Legislation)*, 95th Congress, 2nd session, September 7, 1977.
- U.S. Congress, House of Representatives. Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance. Hearing. *Consumer Checking Account Equity Act of 1979*, 96th Congress, 1st session, May 15, 1979.
- U.S. Congress, House of Representatives. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Hearing. Hearings. *Oversight Hearings on Depository Institutions Deregulation Committee*, 96th Congress, 2nd session, July 2, 1980.
- U.S. Congress. House of Representatives. Committee on Banking, Finance, and Urban Affairs. Hearings. *Conduct of Monetary Policy (Pursuant to the Full Employment and Balanced Growth Act of 1978)* 97th Congress, 1st session, July 14, 1981.
- U.S. Congress, Senate. Committee on Banking, Housing and Urban Affairs, Subcommittee on Financial Institutions. Hearing. *Depository Institutions Deregulation Act of 1979*, 96th Congress, 1st session, June 21, 1979.
- U.S. Congress. Senate. Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions. Hearing. *Depository Institutions Deregulation Act of 1979, Part II*, 96th Congress, 1st session, June 27, 1979.
- U.S. Congress. Senate. Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, *Depository Institutions Deregulation Committee*, 96th Congress, 2nd session, August 5, 1980.

Phone Interviews:

In the course of my research, I was able to interview two people who took part in the legislative processes surrounding the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) and the Garn-St. Germain Act. In studying the passage of DIDMCA, I read numerous memos between Stu Eizenstat, Carter's Chief Domestic Policy Advisor and Orin Kramer, Associate Director of the Domestic Policy Staff. I wrote letters to both men asking them to speak with me about the legislative path traveled by DIDMCA and Mr. Kramer responded that he was willing. I interviewed him by telephone on September 17, 2008. During the course of our interview, Mr. Kramer recommended that I also contact Robert H. Dugger, past Chief Economist of the Senate Banking Committee and Senior Staff Member of the House Financial Institutions Subcommittee. Dr. Dugger also agreed to a phone interview, which took place on November 21, 2008.

MICHIGAN STATE UNIVERSITY LIBRARIES



3 1293 03063 0952