1992

Who Failed? The Press, the Regulators, and Other Contributors to the S&L Losses

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Published In
Peter Dickson has given one interpretation of the history and causes of the S&L failures. I agree with parts, disagree with parts. Rather than pick his arguments apart, I will offer my own interpretation of the history, causes and culpabilities.

Since the role of the financial press is part of the topic, let me begin there. I believe the press failed to inform the public prior to the wave of failures, during the wave of failures and after about the proximate causes of the failures. Information was available as early as the 1970s about the problems of a deposit insurance system when the equity of the insured associations is low or negative. My own interest in the subject began in 1967, when I argued that risks and costs would be reduced if private deposit insurance replaced public deposit insurance provided that the central bank served as lender of last resort. By the mid-1980s, there had been so much discussion by Ed Kane, George Benston, George Kaufman and others that I stopped going to conferences at which the problem was discussed. James Barth and Dan Brumbaugh offered calculations of the accumulated losses and negative net worth of thrifts to anyone who inquired. There were, in short, very low costs of acquiring information about the industry’s problems.

The press did not make use of this information, but neither did the regulators, who paid to have some of it prepared, the administration—including the Treasury and the Council of Economic Advisers -- the Federal Reserve, the Congress and the staffs of the relevant Congressional committees.

I don’t accept as an explanation that the problem was too complex or unexciting. The alleged bankruptcy of the social security system or the budget deficit are discussed repeatedly. These subjects are no more arcane, although it must be admitted that here, too, the press often mangles the story. Further, when the S&L failures came to public attention, the press emphasized two of the least important
issues and, in one case, made the problem worse.

Most of the press concentrated on finding scandals and scapegoats. Congressman Wright, Messrs. Keating and Bush, and some others were hauled before the public as culprits. The public was encouraged to believe, incorrectly, that the S&L problem had been caused by people of bad moral character, cheats, knaves and scoundrels. This is a small part of the problem, as I believe anyone familiar with the history will agree. The press misled the public.

Part of the financial press, including such quality press as the Wall Street Journal added to the problem by tying the thrift problems to the so-called junk bond problem. By 1989 or 1990, this repeated criticism, much of it overstated, encouraged Congress to require S&Ls to sell all their junk bonds at depressed prices. This decision added to the losses at S&Ls by disrupting market making functions in the junk bond market and by increasing supply.

This said, I believe it is wrong to single out the press. The press or media is not the only source of information in the country. The S&L problems were not hidden. The substitution of regulatory accounting principles (RAP) for generally accepted accounting principles (GAAP) shows that regulators knew about the growing problem and chose to hide it. Congressmen took testimony and urged forbearance. They may not have known the full detail, but they could have known, if they tried to find out. Press attention might have forced action, but the information was available without the press.

The Federal Reserve has a platoon of economists working on banking and financial markets. The Fed and the principal banking agencies did little to warn about the problem. These agencies were responsible for the safety and soundness of the financial structure. The Federal Saving and Loan Insurance Corporation, and the Home Loan Banks failed as regulators, but the other financial regulators including OMB and the Treasury Department failed also. The media has not informed the public about these failures. And they have failed to inform the public about the inadequacies of the regulations that remain.

The initiating cause of the very large losses was not the deposit insurance system, the absence of mark to market accounting, or the regulatory system. These
arrangements had been in place for decades. It was not the crooks and criminals that have been so much discussed. All of these factors would not have produced large losses if it had not been for two initiating causes.

The first was inflation followed by disinflation. The second was the regulators mistake of controlling deposit rates at financial institutions. Together, inflation and regulation imposed large losses on financial institutions including thrifts but also banks and mutual savings banks. This reduced the equity in many institutions to the point where many of their owners could take risky gambles with hope of personal gain and foreknowledge that losses would be paid by the taxpayers.

Economists can take credit for warning about the costs of regulation Q controls on interest rates. There was a professional consensus, as near to unanimity as we could expect to find. Presidential commissions, private commissions and individual economists urged repeal of these regulations. We were outmatched by the housing lobby, the thrift associations and other interested parties.

Economists did not agree about the costs of inflation. Economists and policymakers who favored discretionary policies created the inflation that, under the existing regulatory system, transferred much of the equity of the thrift industry to those who took out fixed rate mortgages. The principal beneficiaries from the financial scandal were not the crooks and criminals that have received so much attention. The main beneficiaries were the homeowners with fixed rate mortgages. I don't believe the media have told that part of the story either. In fact, it is surprising that so few journalists have inquired about where perhaps $200 billion of losses went.

The principal lesson to be drawn is that discretionary regulation failed. Congressional oversight failed too, but that failure seems to me less puzzling than the failure of financial regulators, changed with responsibility for the safety of the financial system, to protect the public from inflation and its consequences. The consequences included the destruction of much of the financial structure.

Those who think that the financial problems of the U.S. are unique should look abroad. Inflation, followed by disinflation, has disrupted property markets and damaged financial institutions in many countries. Banks, financial firms and property markets in Japan, Australia, and England continue to experience the after effects of
inflation and disinflation.

Discretionary policies produced the great depression of the 1930s, the great inflation of the 1970s, and the thrift, banking and property market problems of the 1980s and 1990s. Other factors contributed to the financial and property market problems, but without inflation followed by disinflation the problems would have been smaller or negligible.

Many share the blame for the thrift and banking industry losses. The press played its role. But I would choose as the chief culprits the economists and policymakers who continue to favor discretionary policies. In the 1960s they brought us the Phillips curve, and believed that well-intentioned individuals, using judgment, are more reliable than rules for controlling inflation and stabilizing economic activity. Their policies produced the inflation that weakened the capital structure of financial institutions generally and saving and loans particularly.

I draw two lessons from this experience. First, economists, political scientists and policymakers should design and implement rules or institutional arrangements that encourage rule-like behavior. If failed thrifts had been closed when their capital values approached zero, the taxpayers would have been spared most of the losses. Rules requiring mark to market accounting and closure when capital was impaired would have avoided the worst mistakes and the bulk of the losses. Ed Kane's paper develops some of these arrangements.

Second, there is a general lesson for research paradigms. Standard welfare economics and large parts of political science treat the government as a dispenser of public goods. In this work, the government's only concern is to safeguard the public's welfare. The public choice or political economy model views government officials and regulators as individuals who seek their own ends. These ends may include, but are not limited to, public service, provision of public goods or safeguarding the public interest.

Thrift and banking regulators revealed their preferences. They were too much concerned with their own interests, and the perceived interests of Congressmen and other interested parties, too little concerned with the public interest. These flaws in the regulatory system are more general. They reflect a goodwill view of government as
administrator and regulator that remains to be corrected. One of Ed Kane's major contributions was his early recognition, at least twenty years ago, that the conflict between private incentives and the public interest was the principal problem of our system of financial regulation. His paper at this conference reminds us that the problem remains.

Returning to the subject of this panel, there is a moral. Rely on institutions and rules, not the press, Congress, regulators, administrators, or economists' judgments or their concern for the public interest.