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6 Political Foundations of the Thrift Debacle

Thomas Romer and Barry R. Weingast

6.1 Introduction

The collapse of the U.S. savings and loan industry is one of the major economic developments of the 1980s.[1] Current official estimates of the cost to American taxpayers of resolving failed thrift institutions exceed $300 billion over the coming decade. Some knowledgeable observers contend that even that figure is optimistically low.[2]

There has been a torrent of analysis of the thrift debacle. Much of this work has focused on the debacle's economic underpinnings. These economic factors include the adverse interest-rate environment facing savings and loan (S&L) institutions at the beginning of the decade, particularly when coupled with the imbalance in maturities of S&L assets and liabilities. In mid-decade, the collapse of real estate markets in the oil patch and hard times in the farm belt had a devastating impact on S&Ls in those areas. Federal deposit insurance provided what has amounted to a government-backed guarantee that encouraged many thrift institutions to hold increasingly risky assets as their net worth declined. Low capital requirements further encouraged a type of risk-taking behavior that has been characterized as "gambling for resurrection." In a number of spectacular cases, outright fraud and theft have occurred.

The American thrift industry, like the financial services sector in general,

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has been highly regulated for the last half-century. The events of the 1980s have called into question the effectiveness of the regulatory structure and performance. Many of those who have explored the economic aspects of the S&L crisis have at least alluded to regulatory failures. Though some have noted links to the political process generally and to congressional politics in particular (see, esp., Kane 1989a, 1989b, 1989c), there has been no systematic treatment of the political underpinnings of the crisis.

In this essay, we are concerned with documenting these political aspects of the thrift debacle by focusing on the role of elected officials. We contend that, although the industry did face severe economic shocks during the decade, political action—and inaction—played an important role in shaping the environment in which thrift institutions and regulators operated. The regulatory structure in place at the beginning of the decade was itself a political creation. Its key elements—such as deposit insurance, portfolio restrictions, capital requirements, resources available to regulators—were politically determined. Any changes in these elements in response to changing economic environments would also be subject to political forces.

Other writers have detailed the escalating costs associated with delay and regulatory forbearance in the face of mounting problems in the thrift industry during the second half of the decade (see, e.g., Brumbaugh and Carron 1987; Brumbaugh 1988; Barth and Bradley 1988; Brumbaugh, Carron, and Litan 1989; Kane 1989a, 1989b, 1989c; Scott 1989a). We argue that Congress was the major source of regulatory forbearance during the crucial period 1985–87.

Our analytical perspective centers on the institutional structure of congressional decision making and on incentives faced by individual congressmen. These incentives led to interventions by some legislators on behalf of constituents (individuals and thrift institutions) to urge regulatory relief. Systemwide, they also resulted in delay in recognizing the magnitude of the problems facing the Federal Savings and Loan Insurance Corporation (FSLIC). Conflicting interests across key committees of the House and Senate—under different party control during the first six years of the decade—also militated against timely, corrective legislation.

In 1981, 85% of the approximately 3,750 thrift institutions insured by the FSLIC had negative earnings (Barth and Bradley 1988). This was the worst of a series of increasingly unprofitable years for the industry. More significantly, the 1979–81 surge in interest rates had wiped out the industry's net worth, as measured by current market value.[3] Even by the more lenient standards of generally accepted accounting principles (GAAP), there was a marked deterioration in the financial health of thrift institutions.[4] The FSLIC was faced by a record number of problem thrifts. The regulatory response was to merge or liquidate only some of the worst cases and to allow many insolvent thrifts to remain open.

The pattern of easing up on regulatory enforcement was codified in the

Garn–St Germain Depository Institutions Act passed by Congress in late 1982. This legislation had as its primary goal the partial deregulation of the financial sector. It expanded the scope of activities permitted to thrift institutions, and it broadened the type of assets that they could hold. It also relaxed regulatory accounting standards for thrifts.[5] Over the next two years, as interest rates declined, it appeared to many observers that the crisis was over.[6] The number of thrifts that received direct or indirect FSLIC assistance fell (see table 6.1).

As is now well known, 1983 through early 1985 was just the calm before the storm. By late 1985, Edwin Gray, chairman of the Federal Home Loan Bank Board (FHLBB), testified before Congress that FSLIC would require $14–$15 billion in additional funds to handle newly emerging problems. When Congress passed legislation nearly two years later, the magnitude of the thrift solvency crisis had grown to an estimated $50 billion. Yet the 1987 legislation provided only $10.8 billion in additional FSLIC funding, less than regulators had requested in 1985. The problems of the thrift industry continued to mushroom, so that by the time new legislation was once again considered in 1989, the scope of the liabilities facing FSLIC and American taxpayers had exploded to $200 billion.

In this essay, we focus on the issue of how the thrift problem of the mid-1980s transformed so quickly. It is widely recognized that a major factor in the magnitude of the problem has been the behavior of insolvent thrifts. The structure of deposit insurance gave insolvent but open thrifts (what Edward Kane has called "zombie" institutions) strong incentives to undertake high-risk investments. If the investments turned sour (as many of them did), thrift owners had little or nothing to lose—the institution was already insolvent anyway. The additional losses would eventually have to be covered by FSLIC, whose ultimate guarantors were the taxpayers. If, on the other hand, the investment paid off, the thrift might be able to lift itself out of insolvency, with the positive returns going to the thrift's owners. This systematic "gambling for resurrection" has meant that, except in the extremely unlikely event

Table 6.1 **Attrition among FSLIC-Insured Thrifts, 1980–84**

	FSLIC-Assisted		FSLIC		
Year	Liquidations	Mergers[a]	Supervisory Mergers	Voluntary Mergers	Total
1980	0	11	24	82	117
1981	1	27	53	206	287
1982	1	69	182	262	514
1983	6	47	49	107	209
1984	9	18	14	33	79

Source: Brumbaugh (1988, table 3-2).

[a]Includes other types of assistance cases.

that most of the gambles were to pay off, the cost of the eventual resolution of the debacle would grow dramatically.

Gambling for resurrection may well have been largely responsible for the explosive growth of the thrift problem. But why was such gambling allowed? Why did regulators not stop it? Given the rapid growth in the problem, why was Congress so slow to respond? Why was the 1987 legislation too little, too late?

Several hypotheses have emerged to address these questions. Some argue that the regulators were incompetent and failed to do their job. Had the FHLBB only been more attentive to what was going on in the industry, for example, it could have abated the crisis when it was much smaller. A second argument suggests that fraud by greedy thrifts hid the problem from view. A third explanation suggests that the thrifts, through intense lobbying and large campaign expenditures, were able to sway key congressmen to violate "ethical practices" by intervening in the regulatory process on behalf of the thrifts.[7]

Although each of these hypotheses is partially correct, they all miss the key element in the foundations of the thrift debacle. Massive gambling for resurrection was allowed to proceed because Congress intervened in the regulatory process to establish and enforce a policy of *forbearance*. This policy, initiated at the start of the decade, was later expanded in two ways. First, by delaying FSLIC recapitalization (partly by design and partly for other reasons, discussed below) and by keeping recapitalization to low levels, Congress ensured that regulators could force only some insolvent S&Ls to close or reorganize. Second, the FHLBB was generally on the side of forbearance. When regulators did propose to embark on a tougher policy, Congress intervened to prevent enforcement of existing rules and, through new legislation, relaxed many regulatory provisions. Moreover, in many respects, *Congressional behavior with respect to the thrift industry should be seen as fairly routine politics, rather than as an outrageous deviation.* We emphasize the role of Congress over that of the president because the latter generally adopted a more passive stance, reinforcing rather than counterbalancing congressional initiatives favoring ailing thrifts. While the president in principle might have attempted to oppose a policy of forbearance, he did not do so.

Our thesis, then, is that the way Congress handled the emerging thrift crisis fits into a more general pattern of the way Congress responds to constituencies and to regulatory developments. Relatively routine behavior during 1985–87 generated both delay in legislation and the reinforcement of forbearance that allowed thrifts to gamble for resurrection.

To establish this thesis, we begin by summarizing a framework that encompasses the relationship between a regulatory agency and Congress and describes how bureaucratic policy choice comes systematically under congressional influence (sec. 6.2). We then shift to a more specific discussion of the regulatory environment of the thrift industry *circa* 1985 (sec. 6.3). This sets the stage for a somewhat detailed narrative of legislative responses to the

changing economic environment and the regulators' proposals to deal with it (sec. 6.4). This narrative is useful, not primarily because it tells an intriguing story, but because it shows how legislative response fits into the framework we have outlined. As part of the discussion of the 1986–87 legislation, we provide some econometric evidence about the connection of constituent interests to congressional behavior. In section 6.5, we summarize our findings and draw some lessons we think are applicable to other potential debacles.

6.2 Congress, the President, and the Regulatory Bureaucracy

Because many of the strongest effects of politicians occur through indirect mechanisms that are not easily observed, the relationship between elected officials and the ongoing process of regulatory decision making is often misunderstood. In this section, we present a framework for the analysis of regulatory policy-making. We begin with the role of Congress, and then we turn to the president.[8]

We start with the premise that congressmen are motivated in large part to seek reelection—certainly other goals, such as implementing good policy, require reelection. This motivation forces congressmen to respond to the interests in their districts. But this does not mean that constituents' interest are weighed in a uniform way. Rather, weights accorded different interests reflect the degree to which particular interests within the district attend and respond to the actions of a congressman. Since most individuals have only the vaguest notion of their congressman, the main challenge of a congressman is to break through the information barrier. According to Mayhew (1974, 74), "A successful congressman builds what amounts to a brand name," and empirical studies repeatedly show that name recognition is valuable on election day.[9]

The problem of building sufficient recognition to succeed on election day leads congressmen to focus on two types of activities: constituency service and national policy issues (Fiorina 1989). Constituency service includes a wide range of activities, which can be grouped into two categories. First, this service entails the congressman's securing his district its share of governmental expenditures—highway funds, a new post office, urban development grants, sewage treatment facilities, and so on. Also in this category is direct service to individuals and groups, ranging from helping individuals find their lost Social Security checks to intervening in regulatory proceedings on behalf of prominent district interests. Congressmen serve as ombudsmen on behalf of their constituents before a host of regulatory agencies. The large presence of the federal government in the economy implies that the opportunities to play this role are numerous, and this ombudsman activity typically constitutes a major portion of a congressman's efforts. Moreover, the federal system of regulation is designed to be open to the influence of congressmen (Fiorina 1981; McCubbins and Schwartz 1984; McCubbins et al. 1989), as we will discuss below.

The second form of activity in which every member of Congress engages in order to develop a favorable reputation involves specialization in the policymaking process. This is most effectively done through the work of congressional committees. The committee system effectively divides the large set of national public issues into jurisdictions and assigns policy areas by jurisdiction to specific committees. This affords congressmen the ability to specialize on issues that relate to their constituents by obtaining membership in a committee with a policy jurisdiction that is important to the constituency. Because few congressmen can credibly claim a key role in major new legislation, the committee system affords opportunities for many members to specialize and build a reputation for expertise and influence in a specific area.

6.2.1 The Role of Congressional Institutions

The literature on congressional institutions demonstrates that they play a key role in determining the specific form of policy outcomes. Recent work has aimed at formalizing the relationship between institutional structure and policy.[10] For our purposes, what is most relevant is that these institutions set up *multiple veto points,* that is, positions within the institution that can readily delay or prevent legislation on a specific topic from becoming law. A major implication of veto power is that it endows relevant legislators with the ability to protect the interests they represent. Attention to the key veto points goes a long way toward understanding policy choice.[11]

Committees are by far the most important veto points because each committee plays a strong role in shaping policy within its jurisdiction. Part of a committee's power arises from gatekeeping—the ability to keep legislation from coming to a vote by the full House or Senate. Exercising such veto power usually requires the support of the committee chairman and a majority of the committee. Put another way, opening the gates typically requires that the committee chairman and a majority of committee members expect to benefit from the legislation. If the legislation will only make them worse off, then the veto power will be exercised. Committees rarely bring their bills before the entire chamber unless they have the support of a majority. Hence most bills succeed once they get to the floor; that is, once they come up for a vote. In summary, then, committees are powerful because they have a fundamental role in shaping the legislative *agenda* as well as the *substantive content* of legislative proposals.

If committees are the most important veto points within Congress, they are hardly the only ones. The bicameral structure of Congress implies that any legislation must attain majority support in both the House and the Senate. While obvious, this condition can be hard to satisfy when the houses are of different parties, as in 1981–86, when the Democrats held a majority in the House and the Republicans a majority in the Senate. In addition, in each chamber there are players other than committee members who may be relevant for particular issues. In the House, the leadership, in the 1980s, played a

strong role in scheduling and passing legislation.[12] In the Senate, individuals may hold up legislation by filibustering at strategic moments.

Constituency interests represented by congressmen at key veto points gain an advantage in the policy process. Veto power usually assures these interests that legislation will not make them worse off (otherwise it will never make it past the veto point). Though floor majorities, the leadership, and other well-placed individuals such as the president often play important roles, an understanding of committees and their leaders remains central to the analysis of policy formation.

6.2.2 Congressmen and their Constituents

In order to understand the legislative preferences of congressmen, we need to know the types of constituencies they face (Fenno 1978; Moe 1989). The relationship between congressmen and their constituents can be divided into several politically relevant subcategories. The first is a congressman's entire district, that is, his "legal constituency." More relevant, however, are a congressman's supporters within the district who provide resources and votes. These include organized interests such as environmentalists, labor unions, firms, and trade associations. Congressmen are especially attentive to the active interests within their districts, and this attention provides the basis for the commonly observed geographically based dispersion of interests in Congress (representatives from farm states are advocates of farm benefits; those from cities are advocates of funds for local highways and urban redevelopment). Another subgroup consists of those with a potential interest in some policy, but who not only lack an organization, they are nearly completely inattentive and can be mobilized only with great difficulty. A good example are individuals who are induced, through dairy price supports, to pay too high a price for milk. Were they politically active, they might counterbalance milk producers' influence over policy that maintains prices. More generally, taxpayers rarely organize to oppose a specific increase in revenue for some political purpose or to oppose a new loophole. Only on occasion can such a politically latent group play a major role in politics.

A final set of constituents relevant for a congressman comes from outside the district. These constituencies usually have interests that fall within the jurisdiction of a committee on which the congressman serves. This rarely causes congressmen to favor organized interests outside the district over active interests within the district. The typical pattern is for a congressman to receive money and support from groups whose interests are compatible with those in his district or for which the district is inactive or indifferent (Denzau and Munger 1986).

In what follows we use the terms "constituents" and "constituency" to refer to those active interests (whether organized or diffuse, inside the district or out) that play a role in a congressman's support coalition. Hence we exclude those interests within the district that are either latent or outside the congress-

man's group of supporters. For any given issue area, legislative preferences of relevant congressmen, especially those positioned at key veto points, must be assessed. This requires focusing on their constituency pressures, typically by examining the various active and potentially active constituencies likely to be interested in the issue.

6.2.3 The Relationship of Regulatory Agencies to Congress

Because regulatory agencies affect a broad range of interests, it would be surprising to find politicians without the means to influence their decisions. While direct attention through hearings, investigations, and policy pronouncements is relatively sporadic, there are many other, often more effective devices for political influence. These include a complex incentive system that rewards agencies that follow political intentions and punishes those that do not. The routine process of regulatory oversight does not involve systematic congressional intervention. A regulatory agency attuned to congressional interests (particularly those represented on relevant committees) will rarely deviate in such a way as to incur congressional ire. Such deviations, when they occur, can damage an agency and its leaders—resulting, for example, in the removal of an issue from an agency's jurisdiction, cutting off funds, or ruining a regulator's political career. Because of such costs, agencies tend to be attentive to the relevant congressional constituents (Ferejohn and Shipan 1989). Direct intervention, then, is episodic and relatively unusual, not because congressional influence is weak, but because direct congressional attention and participation is required only when agencies go astray.[13]

The structure of congressional institutions assures that committees with jurisdiction over a regulatory agency's policy area play a major role in the agency's fate. It is these committees that handle new legislation and respond to problems with agency performance. Two types of changes in the regulatory environment tend to attract considerable attention by the relevant congressional committees: (1) a change in the economic environment that threatens the regulated industry, and (2) an attempt by an agency to alter the regulatory status quo. In the case of the thrift industry both of these took place.

6.2.4 The Role of the President

In general, the president is concerned about reelection, his party's prospects, and his reputation long after he leaves office—his place in history. These factors lead him to take a wider view of policy issues than do congressmen. Like congressmen, the president is strongly affected by active constituencies. In contrast to congressmen, however, the president's electoral base is necessarily larger. Where congressmen can focus on a narrow segment of the national picture, the president must respond to a broader perspective.

The president is therefore more likely to look beyond active interest groups to reach the larger public. Because he commands national attention, the president can potentially transform the politics of certain policy issues. For a small

set of issues—typically those highest on the presidential agenda—the president can sometimes mobilize the nation against narrow, active interests. But, because he does have limited resources, a president typically husbands his time and effort to those areas of high concern to him where the effort will make a difference. As regards regulation, the president has the institutional capacity to monitor and influence on-going regulatory policy (Moe 1985b). This capacity can be deployed to limit attempts by an agency to change policy course in a manner that hurts presidential interests.

6.2.5 Implications for Regulatory Policymaking

The implications of this view of regulatory politics are as follows. *First,* congressmen on the relevant committees play important roles for ongoing policy decisions within a regulatory bureaucracy. Even though congressmen may not be attentive, members of their active support constituency are. Because congressmen collaborate with these constituents to intervene when regulatory agencies seek to deviate from the constituents' interests, regulators pay close attention to these interests. Intervention by politicians usually means trouble for bureaucrats, and it is widely agreed that agencies seek to avoid it. If an agency presses on in spite of congressional opposition, congressional intervention usually follows. The main lesson for regulatory policy-making is that, in a confrontation between a congressional committee (i.e., committee chair and a supportive committee majority) and an agency, the committee usually prevails.

Second, politicians have a variety of strategies available to them for influencing agencies. Actual legislation is usually not necessary for Congress to get the agency to change course.[14] This allows congressmen to play the role of ombudsman on behalf of their constituents in a way that is not particularly visible to outsiders. When faced with a conflict between regulators and constituents, congressmen nearly always side with their constituents.

Third, when examining a particular regulatory policy initiative, we should distinguish between the actors *implementing* policy and the *political forces* that led to the policy. Too often, students of regulation presume that because a regulatory agency initiates a policy without explicit instructions from politicians, the agency—and not the politicians—must be responsible for the policy change. By the framework we outlined above, this inference is incorrect because it ignores the political forces working on the agency.

Frequently, one can find good evidence of congressional influence by comparing agency proposals with what actually happens, whether through legislation or an agency's implementing a revised proposal. An example is useful here. In studying the 1960s policy initiatives of the Securities and Exchange Commission (SEC), many scholars provided explanations in terms of the agency itself, focusing especially on the preferences of new SEC leaders.[15] Weingast (1984) showed that, in fact, the SEC had been proposing these apparently new policies as early as the 1940s. These proposals fell on deaf

presidential and congressional ears and went nowhere. Only when new officials in the White House and on the relevant Senate committee began to favor these initiatives were they actually implemented.[16]

Fourth, the lineup of constituency interests facing congressmen on the relevant committees, members on the floor, and the president is an important foundation for regulatory policy choice. When only one interest is active, it tends to dominate policy choice, often at the expense of a much larger group of inactive individuals. When several constituencies are relevant, policy tends to be a compromise among them. But here, too, such compromises often come at the expense of inactive interests.

Fifth, presidential action can provide a counterweight to the congressional tendency to favor narrow but active constituencies. Such action typically comes only when it is consistent with the overall administration agenda (and does not significantly conflict with the interests of constituencies that form an important part of the president's support). Because his resources are limited, a president usually plays this role only when issues of the highest priority are involved.

Sixth, when policy initiatives backfire, politicians often blame bureaucrats. This rhetoric is part of the system itself. Because the influence of Congress on the bureaucracy is subtle and not readily known, Congress can rail against the very bureaucracy it created (Fiorina 1981). Moreover, as Kane (1989b) emphasizes, legislation is often constructed so as to give politicians considerable scope to obscure the lines of authority to the bureaucracy. Since the public holds regulators responsible for a host of policy problems, the bureaucracy becomes a convenient whipping boy.

6.3 The Thrift Problem and the Relevant Constituency Interests

6.3.1 Background of the Regulatory Environment

To put the events of the eighties in proper perspective, a brief sketch of the political setting of the thrift industry is useful. Many thrift institutions were formed between the world wars by real estate, construction, and development companies as a natural adjunct to their other activities. The regional Federal Home Loan Bank system was established in 1932 to provide for thrift institutions the services that commercial banks obtained through the Federal Reserve System. The Federal Savings and Loan Insurance Corporation (FSLIC) was established in 1934 as part of a political compromise to gain the support of thrift institutions for Roosevelt's National Housing Act.[17] The FSLIC was placed under the supervision of the FHLB Board.[18]

The linkage between the housing industry and the thrift industry was a politically potent force in the decades following World War II. Much of the argument for the special status of thrifts was based on the premise that a strong housing industry required strong thrift institutions, and that these institutions,

in turn, required favorable treatment to assure a healthy market for residential mortgages.[19]

The geographic dispersion of the thrift industry—with firms in nearly every congressional district—has meant that when the industry required congressional attention, it could usually get it. Through the 1970s, the industry was quite homogeneous in its interests. Consequently, its trade association, the U.S. League of Savings Associations (later renamed the U.S. League of Savings Institutions), was able to marshal considerable agreement on policy matters and to "speak with one voice" to regulators and politicians. Indeed, the league was so effective in making its views known that its name was nearly always accompanied in newspaper accounts by the adjectives "powerful" and "influential."

The relative homogeneity of the industry also worked to its direct advantage with the relevant congressional committees and hence with the industry's chief federal regulator, the FHLBB. Forces tending toward "capture" of a regulatory agency by the industries it regulates are magnified when the regulated interests are themselves not in conflict. The absence of conflict among constituents led to an FHLBB that in many ways has looked like the paradigmatic captured agency: responsive for the most part to thrift industry interests, promulgating regulations that would increase industry rents, staving off competition from unwelcome poachers from commercial banking. Congress supported these policies both with active legislation, and—more generally—simply by not opposing them.[20]

As a response to the straitened economic circumstances faced by the industry at the beginning of the 1980s, the Garn–St Germain Act of 1982 loosened restrictions on thrifts' activities. This helped to provide the industry with greater scope to make investments and compete for deposits. As the adverse interest-rate environment of the early 1980s receded, the apparent health of the industry improved. Encouraged by spokesmen for the thrift industry, most members of Congress were ready to believe that legislation in 1982, coupled with regulatory actions from then on, had succeeded in handling the problems that had surfaced at the beginning of the decade.

During this time, there is little evidence that the FHLBB disagreed with the policy of forbearance. Indeed, a case can be made that warning signs about the looming losses embedded in many thrift balance sheets were systematically downplayed, both by industry groups and by the regulators.[21] The accounting rules adopted by FHLBB pursuant to the guidelines of the Garn–St Germain Act made this possible. The gambles of insolvent thrifts, made with at least tacit regulatory approval, were backed by congressional mandate.

6.3.2 The Administration and the Emerging Thrift Crisis

The administration's domestic policy stance centered on reducing the scope of government activity, including an emphasis on holding down nondefense spending. As far as the thrift industry was concerned, this had three important

implications. First, the administration strongly supported the deregulatory components of the 1982 legislation. It looked at thrift regulators with a somewhat jaundiced eye, at least when it came to the question of bank examination and supervision. Second, to the extent that dealing with the thrift problem required infusions of government funds, the administration preferred not to acknowledge the problem. In part, this reflected the administration's desire to avoid any explicit new revenue requirements. In part, it was due to the recognition that any attempt by the administration to gain revenue for one purpose would require compromise with administration opponents seeking funds for their own favored programs. Third, by late 1986, deferring action on the full scope of the thrift problem allowed the administration to focus on other policy goals as the Reagan presidency approached its end.

A minority voice within the administration recognized the problems inherent with the system of deposit insurance in a deregulated environment. The 1984 *Economic Report of the President* contained a recommendation by the Council of Economic Advisers (CEA) that the deposit insurance system be reformed because of the adverse incentives it created. The 1986 *Economic Report of the President,* published in February, devoted a chapter to "The Federal Role in Credit Markets," which gave a succinct explanation of the thrift problem as of late 1985—including the risks posed by "gambling for resurrection." The CEA also sounded a warning that FSLIC's problems could turn into a potential liability for taxpayers and again called for deposit insurance reform.

The economists' position was not reflected in the administration's policy. The president continued to support further deregulation of financial markets, but there were no initiatives to deal specifically with the problems of the thrifts.[22] A policy of forbearance was consistent with the three factors we listed above. Any other path would have been in conflict with the administration's highest priorities. From the perspective of 1985 and 1986, the stakes in the thrift issue did not appear substantial enough to compromise those priorities. The administration thus withheld support from thrift regulators not only when they attempted to enforce capital requirements but also for new revenue that might have provided an early and much smaller recapitalization of the thrift insurer than would prove necessary later on. Action by the Office of Management and Budget (OMB) to limit FHLBB budget requests (see below) was consistent with this stance.

6.3.3 Regulators and the Emerging Crisis

While the scope of thrifts' lending activities—and hence their asset-risk exposure—increased, the resources devoted to monitoring thrifts' health stayed constant or actually declined. Table 6.2 shows that FHLBB examination and thrift supervisory budgets were roughly constant from 1982 through 1984, whether measured in numbers of people or dollars. Yet, during this time, industry assets grew by 50%. Arguing that the growth in the industry

Table 6.2 FHLB Regulatory Resources and Thrift Industry Assets

Year	Examination and Supervision Resources: Staff[a]	Examination and Supervision Resources: Budget[b] (in millions of $)	Assets of FSLIC-Insured Thrifts (in billions of $)
1979	1,282	41.0	568.1
1980	1,308	49.8	620.6
1981	1,385	52.8	658.5
1982	1,379	57.3	686.2
1983	1,368	62.5	813.8
1984	1,337	67.0	977.5
1985	1,990	108.8	1,070.0
1986	2,986	168.5	1,163.8
1987	3,258	297.6	1,250.8

Source: Barth and Bradley (1988, table 8).

[a]Staffing figures are based on full-time-equivalent personnel engaged in examination or supervision at both the Bank Board and the district Home Loan Banks.

[b]Budget figures are budget or actual expenditures, as available, on examination or supervision at both the Bank Board and the district Home Loan Banks.

required greater regulatory resources, the FHLBB requested a significantly increased budget for 1985. This was rejected by the Office of Management and Budget as unjustified, given the administration's overall stance on regulation as well as its desire to limit government spending.

Even peering through the distorting lenses of regulatory accounting practices, it was becoming apparent to the regulatory agency in 1985 that the gambles of many insolvent thrifts would probably result in heavy losses for FSLIC. A report by FHLBB economists in July 1985 estimated that the present value of the costs associated with dealing with resolving thrifts that were insolvent at the end of 1984 would be over $15 billion. At the time, FSLIC had assets of $5.5 billion. At a Senate Banking Committee hearing, Edwin Gray "emphasized that [the report] painted a worst-case scenario which was very unlikely to occur." Senators Jake Garn (R–Utah, the committee chairman) and William Proxmire (D–Wisconsin, ranking minority member) concurred.[23]

The FHLBB did take some steps to increase its regulatory resources. Having been rebuffed by OMB, the agency decided in mid-1985 to decentralize its examination activities by shifting personnel to the district Federal Home Loan Banks. This ploy allowed the FHLB budget to increase, since the district banks' budgets were not subject to OMB review. The last three years' entries in table 6.2 reflect this administrative shift by the agency.

By the fall of 1985, thrift insolvencies were mounting at a rate that alarmed even the FHLBB. Edwin Gray's announcement in October 1985 that FSLIC needed about $15 billion in new capital to handle insolvent thrifts provided a

clear signal of a change in regulatory position. Gray's change from his stance earlier was driven to a large extent by knowledge within the agency that disaster was impending—FSLIC was clearly going broke. If nothing were done, Gray and the agency would be blamed. Blame might be avoided if the problem were urgently brought to public attention. The FHLBB chairman testified to Congress that were the board to resolve cases immediately, the deposit insurance fund would run out of money within a year.

6.3.4 Congressional Response

The Reagan administration's decision to remain in the background on the thrift issue left Congress as the major player. In looking at congressional response to these developments, two elements should be emphasized. First, it is not unusual for an agency to cry "wolf"—a crisis is emerging—and claim that if its budget is not increased dramatically, life as we know it cannot go on. Why, in a given instance, would congressmen believe the alarm? For the case of the S&Ls, had not the 1982 legislation fixed the problem? In what sense was there a new problem? Even congressmen without a special-interest axe to grind may well rationally react with skepticism to the new tune being sung by regulators.

The second element relevant to the emerging crisis was the fiscal austerity of the mid-1980s. In times of budgetary constraint, nearly all congressmen had to face constituents who wanted funds for existing programs increased, without the political wherewithal for added revenues. To the extent that new resources for the FSLIC or the FHLBB were to come in the form of newly funded budget authority, these resources would probably have to come at the expense of competing programs. To refuse valued, long-term constituents while creating a large new program would be politically difficult. Congressmen (and the president) would thus be reluctant to address any problem with big fiscal requirements unless there were large political rewards to be gained. Since the nature and potential proportions of the problem were not well known, these rewards were likely to be small.

To understand the nature of the political costs and benefits associated with new legislation, we turn to the lineup of interests on this issue.

(1) The Thrift Industry

A key feature of the economic developments in the industry over the 1981–87 period is the growing disparity between the healthy thrifts and those that were not doing well. Table 6.3 shows that the gap between the worst-performing institutions (those in the 5th and 10th percentiles of the industry, as measured by after-tax income) and the ones doing best (those in the 90th and 95th percentiles) widened enormously from 1983 to 1987.

As figures 6.1 and 6.2 show, there was also a geographical segmentation of the industry, with some regions having particularly heavy concentrations of insolvent thrifts.[24] By 1986, concern about the thrift industry would be more

Table 6.3 Net After-Tax Income of FSLIC-Insured Thrifts (annualized, percentage of Average Assets)

Year	5th Percentile	10th Percentile	Industry Median	90th Percentile	95th Percentile
1979	.0	.2	.7	1.1	1.2
1981	−1.9	−1.4	−.5	.4	.7
1982	−2.1	−1.6	−.5	.6	1.1
1983	−1.1	−.8	.3	1.1	1.6
1984	−1.1	−.7	.4	1.0	1.4
1985	−1.7	−.8	.7	1.4	1.6
1986	−3.7	−1.3	.8	1.6	1.9
1987	−7.8	−2.7	.5	1.2	1.6

Source: Barth and Bradley (1988, chart 3).

relevant generally. But, perhaps more important, figure 6.2 reveals that the immediacy of the concern would be manifest more clearly to legislators in the southwest and parts of the farm belt than to those in other parts of the country.

These effects eventually led to a divergence of interests within the industry, but in a way that had both segments of the industry supporting only limited help for FSLIC.

Troubled Thrifts. Troubled S&Ls would seem to be the most likely source of active support for legislation to resolve the problems in the industry. There was indeed active support—but not for increased regulatory activity. Instead, these thrifts, and especially the U.S. League of Savings Institutions, argued for continued forbearance, so that weak and insolvent thrifts could grow out of their current problems, much as they were claimed to have done in 1983. They were opposed to increasing deposit insurance levies to generate more funds for the FSLIC. Generally, they supported a limited recapitalization for FSLIC. This would provide the insurance fund with some resources to handle the worst cases, but not allow it to move aggressively against many insolvent institutions.

Healthy Thrifts. These firms recognized that allowing FSLIC to fail would create depositor uncertainty that would harm even the healthy thrifts, so they preferred some recapitalization over doing nothing. Obviously, healthy thrifts would have liked to shift to taxpayers as much of the cost of resolving failed institutions as possible.[25] But they also recognized that to expect a recapitalization totally financed by taxpayers was unrealistic. At least initially, increases in FSLIC capital would have to be financed in large measure by increased assessments on the industry. If the sick thrifts did not get better, these assessments would have to be borne by the segment of the industry that had a positive cash flow. The larger the FSLIC recapitalization, the larger the cost to

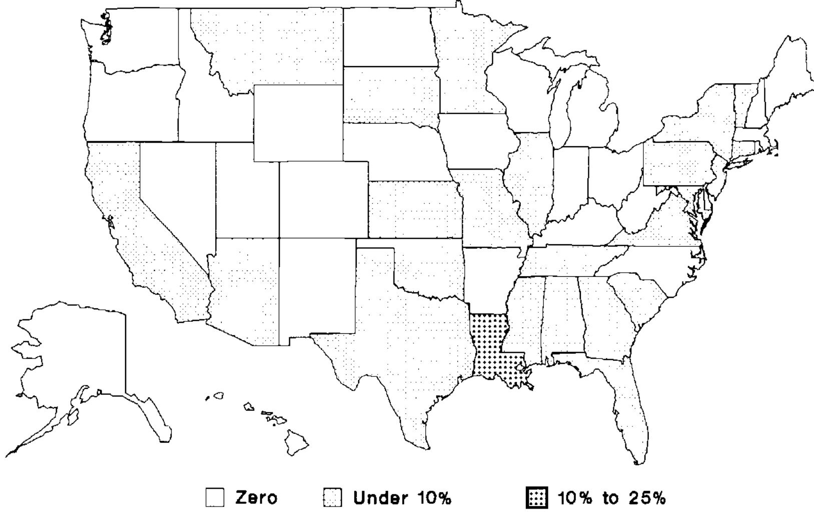

Fig. 6.1 Percentage of thrifts insolvent in 1981

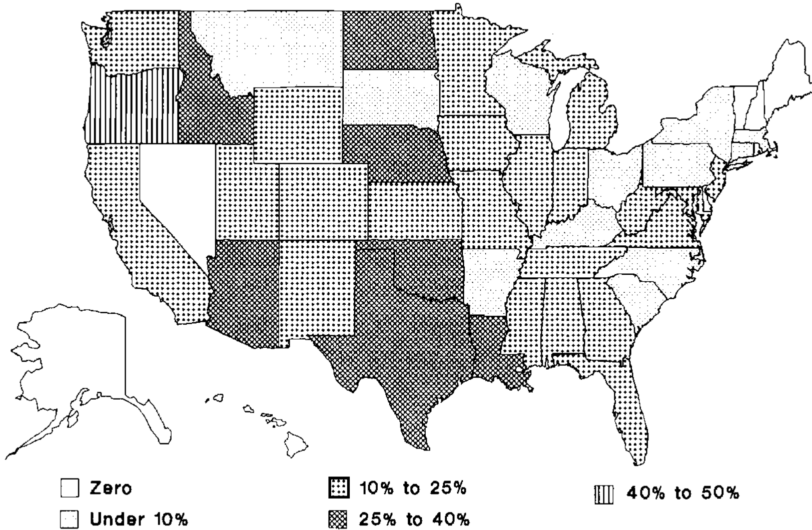

Fig. 6.2 Percentage of thrifts insolvent in 1986

the currently healthy firms—except in the highly unlikely event that many of the zombies were indeed resurrected. A recapitalization large enough to cover all likely losses by zombie thrifts, if borne by the healthy members of the industry, would wipe out most of the healthy thrifts' profits and a substantial portion of their net worth. So, from the healthy thrifts' viewpoint, a large

recapitalization, drawing mostly on industry funds, was not necessarily better than doing nothing. This group was therefore inclined to support a modest recapitalization on the order of $5 billion.

(2) Depositors

The clear preference of account holders was to ensure that the various guarantee schemes—thrifts backed by FSLIC and FSLIC backed by the government—worked as promised. This system of pledges removed the incentives for this group to monitor the institutions that held their deposits. While depositors were likely to react quite strenuously if these pledges were threatened, they were unlikely to play an active role in the choice among different alternatives for honoring the pledges.

Where there were relatively heavy concentrations of failing thrifts, the immediacy of the problem would be more apparent to depositors. In such areas, the concerns of depositors could be strong enough to register on the political seismograph. This effect would pull a congressman's preferences toward a higher FSLIC capitalization, providing a countervailing force against the interests of the troubled thrifts.

(3) Taxpayers

Taxpayers, of course, were the most diffuse constituency. Because of this diffusion, only a few issues ever become sufficiently salient to play a role in the mass politics of taxation. In the short run, this group simply prefers lower taxes. While in principle it may have an interest in spending more money today to avoid spending much more money tomorrow, in practice politicians can act on this principle only if they can credibly claim credit for actually having saved the money tomorrow. Such claims typically look like rationalizations for boondoggles for some other group and are usually avoided by politicians. Prior to the crisis becoming common knowledge, therefore, it was unlikely that politicians could claim credit for saving future taxes by big appropriations today.

While there is a clear overlap between the last two groups, their interests are not identical. Not all taxpayers have significant deposits at thrift institutions. Because depositors are a subset of all taxpayers, they prefer policies that secure their deposits while spreading the costs over the much larger group of taxpayers. For depositors, especially large ones, the benefits in making deposits more secure outweigh their share of the increase in taxes.

This discussion suggests that there was little initial support, outside of a small group of experts, for developing a legislative solution that covered the full scope of the thrift problem. While in late 1985 the problem was big enough to demand some attention, it was not recognized to be large enough to generate sufficient public attention that there were large political rewards from a major new, expensive policy. A recapitalization that would have given FSLIC sufficient resources to resolve all current and expected insolvencies

would, by late 1986, have required a $50 billion program. This level of funding was totally outside the scope of anything that could be financed from assessments on the industry. It would require a significant commitment of taxpayer resources.[26]

It must be emphasized that, while regulators and a small group of experts were warning of dire things to come, no significant group was mobilized to support a large-scale recapitalization. Congressmen were faced with a situation in which the lineup of interests was largely against the high levels of recapitalization called for by some regulators. In such a situation, congressmen did not need elaborate rationalizations to follow their legislative preferences and side with their constituents.

6.3.5 Committee Jurisdictions and Other Interests

In the Senate, the jurisdiction over thrifts is assigned to the Committee on Banking, Housing, and Urban Affairs, while in the House the similarly named Committee on Banking, Finance, and Urban Affairs deals with these matters. As their names suggest, the domain of these committees is extensive, and includes a large variety of issues beyond the S&L industry. Not only were other financial markets and regulatory agencies within their realms, but so too were such diverse policies as housing and even some aspects of international development. A common occurrence in the legislative process is that members of committees with legislative interests in one policy area must negotiate with other members of the committee whose interests lie elsewhere, often in policy issues that are logically unrelated except that they come under the purview of the same committee. This *politically induced interdependence* among issues may have a strong effect on legislation aimed at a particular problem because the fate of one policy may be tied to political circumstances involving other, possibly unrelated issues.

An ongoing matter of concern for both of these committees throughout the 1980s was the question of deregulation of commercial banks. A particularly contentious issue involved the entry into banking of nonbanking institutions, such as Sears and American Express. The regulation of such "nonbank banks" did not directly involve most of the problems confronting the thrift industry. But, in a larger sense, a case could be made that the health of the thrift industry was linked to the overall competitive environment of the banking sector. In any event, over the 1986–87 period, these issues became linked in the political process.

6.4 The Politics of Legislative Delay and Forbearance, 1986–87

In this section we examine the legislative consideration of a response to the regulators' signal that all was not well and that a major change in policy would be needed. The conjunction of constituent interests and the institutional struc-

ture of congressional decision making provides a road map through the events of the two years following Gray's October 1985 testimony. The trail to follow in this narrative is the one laid out by our framework: attention to players at key veto points and their role in structuring the legislative agenda.

6.4.1 The 1986 Stalemate

The reaction by the two committee chairmen to the emergence of a new thrift problem differed in ways that foretold conflict: St Germain (D–Rhode Island, chairman of the House committee) called for extension of the 1982 legislation and opposed further financial deregulation. In contrast, Senate committee chairman Garn announced that he was "vitally committed" to broad financial deregulation. He planned to use the yet undrafted bill to strengthen the FSLIC system as a vehicle for banking deregulation. As will become clear, Garn was not alone in this sentiment. Thus, St Germain, at least initially, sought a bill that focused on the thrift problem. Garn's interest focused on deregulation of the financial system and saw the legislation on the thrifts as a potential vehicle.

In the early spring of 1986, a plan emerged to finance the recapitalization of FSLIC. The FHLBB proposed to tighten regulations concerning thrift investments and accounting standards, arguing that half a decade of permissiveness had done much harm. The new rules would require thrifts, among other things, to double their capitalization to 6% of assets in six years and to replace the current accounting conventions that, according to the board, had obscured the emerging problems. By early May, the proposed plan would raise sufficient funds to cover deposits in the (then) estimated 216 failing thrifts.

Proceedings in the Senate began when Garn introduced an omnibus banking bill that included provisions for dealing with thrifts and other problems. Shortly thereafter, however, he dropped the additional provisions as his committee passed a bill with FSLIC provisions nearly identical to those in the House. Nonetheless, William Proxmire, ranking minority member of the committee, threatened to filibuster unless other, unrelated aspects of bank regulation—especially the issue of the nonbank banks—were dealt with at the same time. In late September, the House committee joined this measure with political alternatives of its own, especially additional authorization for some housing programs, hoping to use the FSLIC recapitalization as a vehicle to move other legislation.

Before a vote on the House floor could be taken, however, majority leader Jim Wright of Texas (who would soon succeed Tip O'Neill as Speaker) removed the bill from the House calendar. Texas bankers and real estate developers had complained to Wright that regulators were restricting real estate loans and refusing to restructure bad loans. The bill was not rescheduled until Edwin Gray met with Wright and assured him that regulators would cooperate with ailing thrifts in Texas. By holding the legislation sought by regulators

hostage, this intervention compelled an agreement by the regulators not to enforce their own rules against ailing thrifts—assuring an expanded de facto policy of forbearance, at least for politically favored institutions.

Shortly thereafter (October 1986), the House passed its measure. The house bill created a new financing corporation with the authority to borrow up to $15 billion over three years, to be used to fund FSLIC. Only a limited amount of new FSLIC resources would come from extra assessments on thrifts. Like the regulators, legislators also proposed changes in the regulatory restrictions. But instead of *increasing* the stringency with which insolvent thrifts were regulated, legislators *weakened* the position of regulators vis-à-vis the zombies. Regulators were given expanded powers, not to force failing banks to close, but to keep them open until new owners could be found or the hoped-for resurrection took place.

On the Senate side, the final bill called for only $3 billion in FSLIC recapitalization and did not include housing provisions that St Germain strongly favored. St Germain had earlier indicated that he would not accept any compromise that excluded the housing issues. At this point a stalemate occurred. None of the policies preferred by House members at key veto points (i.e., policies calling for funds for FSLIC and housing, but *without* provisions dealing with commercial bank regulation) were acceptable to key veto players in the Senate (who supported lower FSLIC recapitalization *without* the housing provisions but *with* the commercial banking matters) and vice versa. With the congressional session ending before the 1986 elections, there was insufficient time to resolve the differences between the Senate and House versions. Both bills died.[27]

The end-of-the-session rush combined with strategies by several politicians to link the thrift issue to other issues. Even a partial resolution of the growing thrift problem was thereby delayed for nearly a year. Part of the explanation for the intransigence of the relevant committee members in both chambers is that those with strong constituency interests were inclined toward lax regulation. Since, for the most part, thrifts were arguing for forbearance, delay would ensure greater laxity by forcing the regulators to wait for needed funds. Committee members with relatively few weak thrifts in their state (such as Proxmire of Wisconsin) did not have a compelling interest in raising substantial revenues for FSLIC but were interested in other banking issues. Finally, there was the general unwillingness by many congressmen to find the FHLBB warnings of impending doom to be credible, given the longstanding appearance (buttressed by regulatory accounting practices and the claims of the thrift constituency) that the thrift problem was at worst a temporary and regional one.[28]

A year of legislative deadlock was not without its legacy. Though no legislation had passed, the regulators' direct interaction with Wright and other members of Congress from states with many problem thrifts (especially Texas, California, Louisiana, Nebraska, and Oklahoma) made it clear that any

future attempts to deal with the thrift problem would involve large doses of forbearance.

6.4.2 Legislation in the 100th Congress (1987)

With the Democrats' recapture of a majority of Senate seats after the 1986 elections, the chairmanship of the Senate committee passed to Proxmire. Within a month of the elections, he announced support for a plan drafted by the administration that would have permitted up to $15 billion in borrowing authority for a FSLIC recapitalization. But he intended to include this in an omnibus bill (S 790) that also placed a moratorium on the creation of new nonbank banks.

The U.S. Savings League lobbied aggressively against the $15 billion recapitalization.[29] They argued against its costs and supported a much weaker proposal that would have allowed for a temporary $5 billion funding authority. This proposal would also have continued and even extended regulatory forbearance toward insolvent thrifts in "economically distressed" areas. In this way, the League proposal combined the forbearance measures sought by the sick thrifts and the limited funding that the healthy thrifts preferred.

As approved by the Senate Banking Committee, S 790 limited FSLIC borrowing to $7.5 billion over two years, with no more than $3.75 billion to be spent in either year.[30] The bill also included forbearance provisions for thrifts in economically depressed areas. Attempts to increase the borrowing limit were rejected by the committee. Most of the debate in the committee focused on issues relating to the nonbank bank matter and other financial sector regulatory questions, such as the entry of commercial banks into the securities industry.

Bill S 790 was approved on the Senate floor 79 to 11 without significant change in the FSLIC financing provisions. An attempt by Garn to strike the non-FSLIC-related matters from the bill to provide a "clean" recapitalization bill failed by a vote of 35 to 54. The committee bill also contained a provision that would have exempted bank regulatory agencies (including the FHLBB) from any automatic Gramm-Rudman-Hollings cuts. Approving an amendment by Gramm (R–Texas) by a voice vote, the Senate stripped this provision from the committee bill. In so doing, the Senate made clear that additional funds for FSLIC would be subject to the general fiscal restraints of the time.

On the House side, St Germain had signaled early on that he would refuse to permit a bill to reach the House floor with the nonbank bank provision, and his committee prepared its own version of the legislation (HR 27). As to the message that the bill would send to regulators, Speaker Wright had met with committee Democrats, and, according to news reports, "Mr. Wright in effect said, no forbearance, no bill" (*New York Times*, 9 February 1987).

As it appeared in the markup session of the Financial Institutions Supervision, Regulation and Insurance Subcommittee of the House Banking Commit-

tee, HR 27 was essentially the bill supported by the U.S. Savings League. The major issue of debate was the level of recapitalization. On a 23 to 20 vote, the subcommittee approved an amendment to raise FSLIC's borrowing limit from $5 billion over two years to $15 billion over five years, with a limit of $3.5 billion on borrowing in any given year. The next day (1 April 1987) the full committee reversed this action, and approved, 25 to 24, an amendment sponsored by Stephen Neal (D–North Carolina) to return to the $5 billion, two-year plan. Amendments to increase the recapitalization to $12 billion over four years or $10.5 billion over three years were rejected. The committee then voted 45 to 5 to report HR 27, with the two-year $5 billion plan, and including many forbearance provisions.

FHLBB chairman Gray attacked the committee bill because, in contrast to the measure the committee had passed in 1986, it included many new forbearance provisions. He noted that these were pushed by "some of the worst-managed thrifts" in order to "hamstring" regulators. Proponents of HR 27 explicitly argued that its main goal was indeed to put regulators "on a short leash" (*Washington Post,* 29 April 1987).

6.4.3 The St Germain Amendment

As FSLIC's cash woes mounted, toward the end of April, Speaker Wright made the surprise announcement that he would favor increasing the capitalization to $15 billion, though with the forbearance provisions of the committee bill left intact. Speculation about Wright's motives included his increasing concern about adverse media coverage of his connection with some spectacular Texas thrift failures and indications that the $5 billion package would fail on the House floor.[31] St Germain joined Wright in this reversal and announced that he would sponsor an amendment to raise the FSLIC borrowing limit to $15 billion—but retain the forbearance provisions—when HR 27 came to a House vote.

The U.S. Savings League lobbied vigorously against St Germain's proposed amendment. Healthy thrifts were particularly concerned about the additional assessments that the higher borrowing limit would impose on them. When the St Germain amendment came to a vote in the House (May 5), it lost by a resounding 153 to 258.[32] The leader of the floor fight against the amendment was Neal, who put the issue in the following terms: "The argument is between more money and less oversight [of the regulators by Congress] and less money and more oversight" (*Wall Street Journal,* 6 May 1987).

We conducted a simple econometric analysis of voting on the St Germain amendment to examine our hypothesis that the opposition of healthy thrifts played an important role in defeating the amendment. We obtained data on the number of FSLIC-insured thrift institutions falling into each of five GAAP capital/asset ratio categories in each state.[33] We constructed two variables, WEAK and STRONG. The former is the number of thrifts in the state with negative GAAP net worth, while the latter is the number of those with GAAP net

worth above 3% of GAAP assets. Both variables were measured as of year-end 1986.[34] We then divided each variable by the number of congressional districts in the state to get an admittedly crude measure of the constituency pressure on each member. (Ideally, we would have liked these data by congressional district, but these were not available to us.) The resulting variables are WEAKDIS and STRONGDIS, respectively.

As another thrift constituency variable, we constructed PACMONEY, which measures the campaign contributions received (in thousands of dollars) by each congressman from the largest thrift industry PACs in the 1983–84 and 1985–86 election cycles.[35]

To capture purely partisan effects, we used party affiliation (a dummy variable PARTY, which equals 1 for Democrats and 0 for Republicans). Another variable, IDEOL, is intended to capture a congressman's general legislative preference with respect to government intervention. The variable IDEOL is computed from scaling of the roll calls and legislators in the 100th House using the NOMINATE procedure of Poole and Rosenthal (1991). This variable ranges from approximately $+1.3$ to approximately -1.3, with high values corresponding to "liberal" positions and low ones to "conservative" positions.[36] Including IDEOL allows for within-party variation according to individual constituency or representative characteristics that are not captured in our economic variables. Finally, we allowed for the possibility that members of the committee behaved differently than nonmembers by including COM, which equals 1 for committee members and is 0 otherwise.

We estimated the probability of observing a "yea" vote on the St Germain amendment. Using probit analysis, we estimated

$$P \equiv \text{Prob (yea vote)} = F(Z), \quad (1)$$

where $F(\cdot)$ is the standard normal cumulative distribution. Our specification of Z is given by:

$$Z = \beta_0 + \beta_1 \text{ PARTY} + \beta_2 \text{ IDEOL} + \beta_3 \text{ COM} + \beta_4 \text{ PACMONEY} + \beta_5 \text{ STRONGDIS} + \beta_6 \text{ WEAKDIS}. \quad (2)$$

Based on our earlier discussions, we expect β_5 to be negative. To the extent that "liberal" overall legislative preferences are also "proregulation," we expect $\beta_2 > 0$. Since the St Germain amendment was supported by the administration, Republicans would be more likely to be in favor of it, so we expect $\beta_1 < 0$.

The committee had, of course, reported the $5 billion package, but this amount had been approved in committee by a one-vote margin. The committee chairman was now sponsoring an amendment to raise the recapitalization level—a switch from the way he voted in committee. This does not imply any clear prediction about β_3, but if committee members tend to support the chairman's position on the floor (as part of an implicit bargain in a continuing relationship), then we should see $\beta_3 > 0$.

The predicted sign of β_6 is negative if WEAKDIS is primarily a measure of constituent pressure from insolvent thrifts. But, as we noted in our earlier discussion, having a larger number of insolvent thrifts in one's district also heightens depositors' concerns in the district. This may lead to increasing willingness to vote for a larger recapitalization.[37] The net effect on β_6 is unclear.

As to β_4, it would be natural to suppose that higher contributions from the thrift PACs would be associated with a lower probability to vote for the amendment. But studies of the relationship of campaign contributions to voting on individual roll calls have shown no clear indication of such direct association.

Table 6.4 presents our probit estimates. As expected, Republicans were more likely to vote for the amendment than Democrats—and liberal Democrats (there are no Republicans with high IDEOL values) were more likely to vote yea than their more conservative brethren. Committee members were more likely to favor the amendment, ceteris paribus, than nonmembers (indeed, committee members voted 30 to 18 in favor[38]). Money from PACs does not appear to have had a significant, independent association with voting yea.[39]

We see that the coefficient on STRONGDIS is negative and quite precisely estimated in all the specifications. Both the estimated coefficient and its standard error are insensitive to which of the political variables are included in the specification. We can say with some confidence, therefore, that the probability of voting *against* raising the FSLIC borrowing limit was significantly

Table 6.4 Voting on the St Germain Amendment to HR 27, Probit Estimates (N = 411)

	1	2	3	4	5
Constant	.287	.014	−.130	.081	−.134
	(.199)	(.182)	(.168)	(.142)	(.164)
PARTY	−1.225	−.250		−1.164	
	(.303)	(.130)		(.291)	
IDEOL	.819		−.011	.778	
	(.228)		(.099)	(.217)	
COM	.728	.675	.679	.756	.680
	(.227)	(.224)	(.223)	(.200)	(.222)
PACMONEY	.037	.042	.038		.038
	(.040)	(.040)	(.040)		(.040)
STRONGDIS	−.072	−.078	−.077		−.077
	(.029)	(.029)	(.029)		(.029)
WEAKDIS	.130	.060	.060		.061
	(.071)	(.068)	(.069)		(.068)
ln likelihood	−251.45	−258.04	−259.87	−255.92	−259.88

Note: Estimated asymptotic standard errors are in parentheses.

Table 6.5 **Probability of Yea Vote on St Germain Amendment to HR 27**

	Means (1)	Low STRONGDIS (2)	High STRONGDIS (3)	Low WEAKDIS (4)	High WEAKDIS (5)
Democrat at median Democrat IDEOL	.305	.414	.192	.258	.397
Republican at median Republican IDEOL	.394	.510	.265	.341	.492

Note: Computations are based on estimates in column (1) of table 6.4. (*a*) For all computations, COM = 0. (*b*) Median IDEOL for Democrats = 0.745. (*c*) Median IDEOL for Republicans = −0.456. (*d*) Maximum value of IDEOL = 1.34; minimum value of IDEOL = −1.41. (*e*) Col. 1: Economic variables at their means: PACMONEY = 1.112, STRONGDIS = 5.032, WEAKDIS = 1.087. Col. 2: STRONGDIS = 1 and PACMONEY and WEAKDIS at their means. Col. 3: STRONGDIS = 10 and PACMONEY and WEAKDIS at their means. Col. 4: WEAKDIS = 0 and PACMONEY and STRONGDIS at their means. Col. 5: WEAKDIS = 3 and PACMONEY and STRONGDIS at their means.

higher, ceteris paribus, for members from states where the average number of healthy thrifts in a district was higher. The effect of the presence of sick thrifts is somewhat ambiguous; though the estimate of β_6 is positive, it is much less precisely estimated than β_6.

To get a sense of the importance of the thrift constituency variables, we used the specification in column 1 of table 6.4 to compute the probability of voting yea on the amendment for two types of hypothetical congressmen not on the House Banking committee.[40] One is a Democrat whose IDEOL has the median value for all Democrats (0.745); the other is a Republican at the median of Republican IDEOL (−0.456). For each of these congressmen, table 6.5 shows *P*, the estimated probability of voting yea, as the value of WEAKDIS or STRONGDIS varies.

Not surprisingly, *P* is generally below 0.5, reflecting the fact that the amendment lost by a 2:1 majority among noncommittee members. As noted in column (1) of table 6.5, for our hypothetical Democrat, $P = 0.305$ when PACMONEY, STRONGDIS, and WEAKDIS are at their sample mean values (for the Republican, $P = 0.394$). Moving from the mean value of STRONGDIS (≈ 5) to its lowest value in the sample ($= 1$), increases the probability of a yea vote by about 33%, to $P = 0.414$. On the other hand, a change from column (1) to a STRONGDIS = 10 (a change of about two standard deviations from the mean) reduces *P* by about one-third, to $P = 0.192$. Changes for the Republican are similar, though less pronounced. The table displays similar calculations for changes in WEAKDIS, which go in the opposite direction.

To summarize, the condition of thrifts in the congressman's state was clearly related to his legislative preferences in voting on the key amendment in the recapitalization debate. Because the number of healthy thrifts exceeded that of weak thrifts in most states (by more than a factor of two in many cases), the effect of STRONGDIS predominated for most congressmen. The net

effect, by our estimates, was to reduce the probability of a yea vote in nearly all districts.

There were no comparable roll calls in the Senate. Presuming that similar forces operated in that chamber, our findings are consistent with Proxmire's willingness effectively to veto legislation in 1986, and with his intransigence throughout the FSLIC debate. In a state with only healthy thrifts, any constituency pressure he faced on the issue would be in the direction of delaying recapitalization or reducing its level.

With the defeat of the St Germain amendment, HR 27 was adopted by the House, 402 to 6. There were no other controversial amendments to the bill reported by the committee. The Senate had also approved its committee's bill (S 790) with only minor changes. This lack of controversy on the floor provides additional evidence for our thesis that there was not a significant constituency for confronting the full magnitude of the thrift problem or to curtail—rather than to extend—forbearance. Even a small group of dissenters can require roll call votes. In this way, the dissenters can force their opponents to go on record against a position, while the dissenters signify their concern on the issue. The virtual absence of roll call votes on the thrift issue in 1986–87 is like Sherlock Holmes's dog that did not bark in the night. It is mute testimony to the fact that members of Congress did not believe there was an audience to whom it was worth sending stronger signals about the thrift problem.[41]

6.4.4 Compromise in Conference: The Competitive Equality Banking Act

As the House and Senate conference committees prepared to meet to resolve differences between the two bills, administration spokesmen indicated that the president was seriously considering a veto of any bill that did not raise the recapitalization limit or—more important—relax the restraints on nonbank banks. As to raising the FSLIC limit, Proxmire "told an industry group . . . that the Treasury Department and the bank board are exaggerating the urgency of the FSLIC's problem and that he would not be pressed into quick action" (*New York Times*, 5 May 1987).

By the end of July, as conferees were meeting, the General Accounting Office reported that FSLIC was $6 billion in the red and was confronting future claims up to $50 billion. In an agreement with the administration, leaders of the conference committee agreed to raise the FSLIC borrowing limit to $10.8 billion, with not more than $3.75 billion to be raised in any one year. The forbearance provisions were left intact. In early August, both chambers passed the conference report (the House by 382 to 12 and the Senate by 96 to 2).[42] The president signed the Competitive Equality Banking Act on 10 August 1987.

The final legislation reinforced continued forbearance by allowing thrifts in farm and oil-patch states to continue to use the lenient regulatory accounting practices adopted in 1982. Thrifts in these areas (and other areas deemed economically depressed) would also be allowed to stay open with a .5% capital-

asset ratio, instead of the 3% required by existing law. The act also explicitly reaffirmed the commitment that the "full faith and credit" of the U.S. government stands behind FSLIC. Given the limited amount of new FSLIC funding relative to the magnitude of the thrift insolvency problem, the act ensured that many failing thrifts would have considerable more time to gamble for resurrection. The crisis would grow.

6.5 The Thrift Debacle and Beyond

The policy of forbearance did not, of course, lead to the resurrection of the zombie thrifts. Instead, as many economists had warned, the losses incurred by thrifts gambling for resurrection continued to escalate. The net income of the thrift industry for 1988 was −$12.0 billion, down from −$7.8 billion in 1987. Barth, Bartholomew, and Bradley (1989) report that the estimated cost of the 205 thrift resolutions begun in 1988 is $31.8 billion. Over half of these thrifts had been GAAP-insolvent for more than three years before they were closed or merged. At year-end 1988, there were 364 thrifts that were insolvent but still open. Many of these thrifts had been insolvent for a long time—some for as long as 10 years (Barth, Bartholomew, and Labich 1990).

Congress did not return to the thrift problem in 1988. By the time the woes of FSLIC reappeared on the legislative agenda after the 1988 elections (in which they played little or no role), the costs of delay and forbearance were increasingly evident to nearly everyone. The 1989 "bailout" (Financial Institutions Reform, Recovery, and Enforcement Act, or FIRREA) was enacted in the context of predictions that the liabilities facing FSLIC were expected to exceed $200 billion.[43] The FIRREA and its legislative history are beyond the scope of this paper. But its enactment was necessitated by the legislative failures of the previous five years.

While it is now widely recognized that a policy of forbearance under the existing structure of deposit insurance has been a prime contributor to the escalation of the thrift debacle, the political foundations for this behavior are not as widely appreciated. This paper has pointed to these foundations as being rooted in the logic of the connections between elected officials and regulatory policy. By this view, regulatory agencies are viewed not as autonomous decision makers, but as actors closely tied to the political system. Constituency pressures work on regulators through the (often implicit) connections with politicians.

The legislative response to the problems of the thrift industry in the 1980s is an excellent example of how this process works. In summary, we note the following:

1. *The political process provides at least tacit support for regulatory policy when the policy is consistent with the preferences of active constituent groups.* This characterized policy toward thrifts until the late 1970s.

2. *Significant changes in the economic environment typically lead to con-*

stituency pressures for regulatory change. This change may be initiated by the regulatory agency, but to be sustainable, it must meet congressional and presidential approval. The 1982 legislative response to the erosion of thrift profitability—deregulation coupled with forbearance for sick thrifts—can be seen in this light.

3. *Regulatory change that is resisted by active constituencies and not supported by other active constituencies rarely succeeds.* In 1985 the FHLBB appeared to be deviating from its earlier course. The 1986 stalemate in refinancing FSLIC and the 1987 legislation worked—through delay, direct intervention, and explicit limitation on FSLIC resources—to rein in the FHLBB. The president, because he can command national attention, is the primary political actor with the power to counter narrow constituency pressure. In the case of the thrifts, the president opted for a stance that did not oppose the congressional tendency toward forbearance.

4. *The emergence of constituencies for whom an issue becomes more salient can alter legislative policy preferences.* As the scale of insolvencies grew, depositor concern over FSLIC solvency also mounted. By late 1988, the policy preferences of the insolvent thrifts (in favor of continued forbearance) were more strongly opposed by concerns about the viability of deposit insurance guarantees. As our empirical results on the St Germain amendment suggest, this would lead to an increase in support for larger levels of FSLIC capitalization. Moreover, once the required funding exceeded an amount that could be covered mostly by assessments on the industry (around $15–$20 billion over five years), healthy thrifts would no longer oppose *additional* amounts. The financing costs of such increments would come from general revenues; deposit guarantees financed in this way would benefit healthy thrifts.

6.5.1 Information and Policy Choice

It is sobering to note that the political behavior surrounding the thrift debacle is absolutely ordinary. Through 1988, congressmen behaved as they do in ordinary circumstances: paying solicitous attention to active, well-organized interests, provided that the readily apparent costs to their other constituents are not noticeably high.

It is an intriguing question whether congressmen would have acted differently had they "really known" in 1986 that delay, forbearance, and intervention would lead to a $400 billion (or more) debacle. If by "really known," we mean that there was a widely shared consensus held by broad constituencies, then the answer to the question would probably be yes. But this was not the situation. It is no doubt correct to say that any economist who thought seriously about the situation would have seen that the combination of forbearance and deposit insurance was a recipe for disaster. Some economists actually said so, within the regulatory agency and outside it.

But the more widespread belief, reinforced by constituency pressures, was that—as in 1982–84—the problem would abate rather than explode. To a

large extent, of course, this perception was created by the very process of the forbearance that politically endorsed policies made possible. Accounting procedures and regulatory reporting effectively minimized the magnitude of the losses. This put most congressmen in the position of "not knowing" the consequences of forbearance. The lack of an active constituency against forbearance (together with knowledge that agencies often cry "wolf") allowed congressmen to act in standard ways; namely, to intervene in the regulatory process on behalf of their constituents. Thus, even in the face of the GAO predictions that FSLIC was facing a $50 billion problem in 1987, nothing near this level of recapitalization was ever on the political agenda in that year. Nor was there any consideration of restructuring the guarantees under deposit insurance.

6.5.2 Beyond the Thrift Debacle

Given the nature of incentives facing politicians, it is extremely difficult for Congress to deal at a sufficiently early state with emerging policy problems that may turn into catastrophes if left unattended. Unless they can claim credit for actions to stem the crisis today, congressmen face great difficulties in bucking the current set of interest group forces. Perversely, even when congressmen know that policy crises are emerging, they may have to wait for the crisis to occur before they can take and be rewarded for remedial actions. Part of the foundation for this tendency is that individual legislators are not seen by their voters as playing a role in the problem. They are not penalized for letting the problem grow.

These considerations are particularly relevant because many aspects of the thrift debacle appear now to be replicated in several other financial problems that loom on the congressional horizon—the solvency of commercial banks, farm loan guarantee programs, and various government-guaranteed pension systems.[44] If the wrong lessons are drawn from the thrift debacle, similar crises may reappear in new settings.

It is tempting to explain the thrift debacle as a story about greed, fraud, and criminal behavior. Surely these are part of the story. It is also tempting to argue that this was a case of regulators in bed with the industry they were supposed to oversee. This certainly also played a role. But underlying these factors is the essential component: Congress sanctioned regulatory forbearance and actively intervened when regulators sought a new, more restrictive path.

In order to argue that the next potential crisis would unfold differently, one would need to demonstrate that structure or incentives have changed. It is possible that, in commercial banking, for example, healthy firms will behave differently than such firms did in the thrift industry. They may perceive that early action to deal effectively with insolvencies is in the long-run interest of the rest of the industry. But it is also possible that, in each case, the regulated interests will remain major constituents of politicians and will argue against forceful regulators.[45] Will politicians be more wary? The answer to this de-

pends on the degree to which currently diffuse interests—generally, taxpayers as a group—see their representatives as having played a major role in the crisis. By moving the focus to shifty operators in the industry or by blaming incompetent or biased regulators, the political source of the crisis will be obscured.

Notes

1. We will sacrifice some precision and use the terms "savings and loan" and "thrift" interchangeably to mean federally insured thrift institutions (which include both S&Ls and some mutual savings banks).

2. The *Wall Street Journal* reported on 6 April 1990 that Congressional Budget Office and General Accounting Office projections of spending through the 1990s will be between $300 billion and $350 billion, "*before* factoring in increased net losses from an unexpectedly greater number of [thrift] insolvencies" (emphasis in original). The article quotes estimates by close observers of the industry that the likely 10-year cost will exceed $400 billion.

3. By 1981, market-value net worth of federally insured thrifts had fallen to − 17.3% of total assets (Brumbaugh 1988, 50, table 2-7).

4. In 1982 nearly 10 percent of FSLIC-insured thrifts were insolvent by GAAP standards, more than in any prior year (Brumbaugh 1988, 37, fig. 2-1).

5. Prior to the Garn–St Germain Act, the Federal Home Loan Bank Board (FHLBB) had eased some accounting rules to help ailing thrifts, by lengthening the list of items that could be excluded as liabilities and those included as assets, in computing net worth. Under Garn–St Germain, "well-managed" thrifts with net worth between 0.5% and 3% of assets could issue "net worth certificates" that could be exchanged for FSLIC promissory notes and counted as assets. In this way a thrift institution could convert what was, in effect, a liability into an asset. Moreover, once FSLIC agreed to buy such certificates from an institution, it was committed to continue buying them as long as the institution was deemed to be "well-managed."

6. A typical report, carried in the 13 August 1983 issue of *National Journal*, proclaimed that Garn–St Germain had "rescued" the thrift industry and that thrift executives were optimistic about their new options.

7. Kane (1989b) provides a good overview of the first and third of these hypotheses. Explanations that lean heavily on fraud and skulduggery are presented in a spate of "inside story" books: e.g., Adams (1989), Pizzo, Fricker, and Muolo (1989), Pilzer and Dietz (1989). Movie versions cannot be far behind.

8. Our discussion is based on a large and growing literature on this topic: Fiorina (1981), Fiorina and Noll (1978), Ferejohn and Shipan (1989), McCubbins and Schwartz (1984), Kiewiet and McCubbins (1991), McCubbins, Noll, and Weingast (1989), Moe (1985a, 1989), Weingast (1984), and Weingast and Moran (1983). For a survey of some of this work, see Romer and Rosenthal (1987).

9. On recognition, see Jacobson (1987).

10. This line of work has provided insights into equilibrium and comparative statics, applied in a variety of settings. See, e.g., Romer and Rosenthal (1978), Weingast and Moran (1983), Ferejohn (1986), Ferejohn and Shipan (1989), and Kiewiet and McCubbins (1991).

11. This is emphasized in Gilligan, Marshall, and Weingast (1989).

12. On the role of the House leadership in the 1980s, see Sinclair (1989).
13. This argument is based on McCubbins and Schwartz (1984) and Weingast (1984). On oversight, see also Aberbach (1990) and Ogul and Rockman (1990).
14. See Kiewiet and McCubbins's (1991) discussion of delegation and Ferejohn and Shipan (1989) on the legislative threats of intervention in agency decisions.
15. See Weingast (1984) for a review of the literature and evidence for this claim.
16. Other examples abound. See esp. Ferejohn and Shipan's (1989) study of Federal Communications Commission policies after the AT&T divestiture and Weingast and Moran's (1983) study of the rise and fall of consumer activism by the Federal Trade Commission.
17. Thrifts had objected to the federal mortgage insurance provisions of the Housing Act, fearing that they would increase the ability of commercial banks and insurance companies to compete in the mortgage market. On this, and for other details of the history of the thrift industry, see Woerheide (1984).
18. This arrangement differed from the case of the FDIC, which was made an agency independent of the Federal Reserve Board.
19. The economic argument for subsidies to mortgage lenders as a way to encourage demand for housing is a weak one and had been frequently challenged—by economists, if not by developers and thrift institutions; see e.g., Meltzer (1981) and Weicher (1988).
20. Robert Litan's comments (in this volume) provide some details on regulatory developments before 1982.
21. Since the early days of deposit insurance, economists had pointed to the perverse incentives for bank risk taking that it created. Barth and Bradley (1988) quote observers from 1931 and 1936 on this point. By the early 1980s, some FHLBB economists were warning about the riskiness of allowing zombie thrifts to operate, and those outside the industry were calling attention to this problem as well; see Kane (1985, 1989b).
22. In the 1986 *Economic Report of the President,* for example, the president's report itself (as distinct from that of the CEA) carried the message that continued deregulation of financial institutions should proceed apace. The thrifts were not mentioned.
23. This quote is taken from an Associated Press dispatch filed by Martin Crutsinger, 26 July 1985; see the analysis in Barth et al. (1985a, 1985b) and Brumbaugh and Hemmel (1984).
24. Figs. 6.1 and 6.2 are based on year-end data, using GAAP definitions.
25. Their position, as described by banking consultant Bert Ely, was, "After all, Ford and GM didn't bail out Chrysler. Boeing didn't bail out Lockheed" (*Wall Street Journal,* 22 July 1987).
26. Given the economic status of the thrifts, even a $15 billion recapitalization would have required assessments of over $1 billion per year and would have cut severely into the income of the segment of the industry that was healthy in 1986. By 1987, tangible net worth (GAAP net worth minus certain items such as goodwill) of the industry had shrunk to $9 billion. Thrifts with GAAP capital-to-asset ratio above 3% had tangible net worth of $34 billion. Tangible net worth of the rest of the industry was *negative* $25 billion (Barth et al. 1990, table 1).
27. Congressional deadlocks of this sort can sometimes be broken by presidential intervention. This did not occur, as the administration was willing to acquiesce in the existing policy of forbearance.
28. Kane (1989b) provides a good discussion of the extent to which accounting numbers systematically provided rosy pictures of the thrift situation.
29. The lobbying and campaign financing activities of thrift industry groups and individual thrifts on this issue have been well documented; see, e.g., Jackson (1988).

30. Although we refer to FSLIC borrowing, under all of the plans discussed here the actual borrowing was to be done by a newly created financing corporation (FICO). The principal on the borrowed amounts would be secured by zero-coupon bonds issued by the Treasury. Interest on FICO borrowing would be paid by FSLIC-insured thrifts.

31. The day before Wright's announcement of his support for the $15 billion limit, the FHLBB "filed a $350 million lawsuit against seven former officers of the Vernon Savings and Loan Association of Dallas charging them with looting the organization of hundreds of millions of dollars. Vernon was one of the thrift institutions for which Mr. Wright had sought leniency" (*New York Times*, 29 April 1987).

32. The St Germain amendment is *CQ* Roll Call 83. Democrats voted 81 yea and 160 nay; Republicans voted 72 yea and 98 nay.

33. The categories are: (GAAP net worth/GAAP assets) less than 0; between 0 and 1.5%, between 1.5% and 3%; between 3% and 6%; and over 6%.

34. Using year-end 1987 data instead did not affect our qualitative results, nor did defining WEAK as thrifts with GAAP net worth less than 1.5% of GAAP assets or STRONG as those with GAAP net worth above 6%.

35. The PACs are those affiliated with the U.S. Savings League and with the National Council of Savings Institutions (Thriftpac). These were the only two thrift PACs among the 500 largest (in terms of campaign contributions) PACs in 1985–86. The totals do not include "soft money" or honoraria received by congressmen from thrift industry groups.

36. We thank Keith Poole for the data. The IDEOL variable for each congressman equals the coordinate of the first dimension estimated from running two-dimensional NOMINATE on the 100th House. The IDEOL variable correlates highly (over .9) with the more familiar ADA score, but is based on a much wider set of roll calls. For details, see Poole and Rosenthal (1991).

37. This could be more directly tested with a variable that measured the number of depositors with accounts at insolvent thrifts in the district. We did not have such a variable at our disposal.

38. That this may have involved strategic voting by at least some committee members has not escaped our attention. All members who, in committee, had voted to keep the borrowing limit at $15 billion, voted for the St Germain amendment on the floor. Five members (including St Germain) who had voted to reduce the limit from $15 billion to $5 billion in committee, switched their position and voted for the St Germain amendment on the floor.

39. It should be recalled that PACMONEY is an imprecise and almost certainly understated measure of actual contributions (see n. 35 above). It is not clear how the "true" measure and our measure would be correlated.

40. Column 1 of table 6.4 is the specification that follows directly from our discussion. Likelihood-ratio tests of comparisons with the results of the other columns also argue in favor of the col. 1 specification.

41. In 1986 there was one roll call vote in the House dealing with thrifts; there were none in the Senate. In 1987, aside from final passage, there were two roll call votes on HR 27 in the House and two on S 790 in the Senate.

42. At first, the U.S. Savings League announced that it would oppose the compromise, saying that the borrowing limit was excessive. Given the GAO report, however, it was unlikely that many congressmen would have been willing to reopen the issue for a major floor fight. Final passage of the bill in the House did require a parliamentary manoeuvre. "Because the conference report broke new ground, beyond the scope of either the House or Senate's original bills, it was vulnerable to a point of order on the House floor. St Germain appealed to the Rules Committee for a waiver of this and other procedural points that might have deterred final passage. In the end, the Rules Committee granted the waivers on a voice vote" (Congressional Quarterly 1988, 636).

43. Some observers have noted that FIRREA does not address many of the fundamental problems facing the industry (see, e.g., Barth and Brumbaugh 1990; Scott 1989b).

44. Commercial banks are the most directly related concern. See Starobin (1989) and Brumbaugh, Carron, and Litan (1989).

45. As of this writing, congressmen from New England have called bank regulators to task for being too vigorous in dealing with commercial banks with weak balance sheets (*Wall Street Journal,* 12 April 1990). While gratifyingly consistent with our thesis, such a development hardly bodes well for taxpayers in the 1990s.

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Comment Robert E. Litan

Thomas Romer and Barry R. Weingast join the growing industry of economists, journalists, and now political scientists who have been attempting to explain the worst financial crisis since the 1930s: the thrift disaster of the 1980s. The entry of political scientists into this fray is welcome. For Romer and Weingast are correct when they argue that the fundamental causes of the thrift mess are political rather than economic or criminal.

Not that economics or flagrant abuse of the law have not mattered, because they have. The lifting of the deposit insurance ceiling from $40,000 to $100,000 in 1980 contributed to the massive risk-taking in the thrift industry that occurred thereafter. The flat-rate feature of deposit insurance pricing, which allowed the drunk drivers of the system to pay no more for their insurance then the safe drivers, also played a part. And the number of books and articles on the rampant insider abuses and fraud among thrift owners and managers clearly demonstrate that criminal activity played a role as well.

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But each of these explanations raises still additional questions. Take deposit insurance, for example. While I have been among those who have argued that the banking industry is in poorer health than reported either by the banks themselves or by the Federal Deposit Insurance Corporation (FDIC) (Brumbaugh and Litan 1990), no responsible observer claims that the cost of actual or hidden bank failures has been even close in magnitude to the costs of resolving the thrift crisis. Yet the deposit insurance system for banks and thrifts has been identical (but for a somewhat higher differential in the flat-rate insurance premium for thrifts since 1985). How then can deposit insurance be the sole cause of the thrift problem, as certain would-be reformers of deposit insurance implicitly, if not explicitly, claim.?

Meanwhile, although fraud and insider abuse appears to have contributed to many, if not most, thrift insolvencies, there are no reliable estimates to indicate what portion of the cleanup *cost* is due to criminal activity. My own guess—and it is just that—is that the figure is 20% or below. Others certainly will have different intuitions.

But the exact figure does not matter because, in my opinion, there is a more fundamental reason why so much criminal or near-criminal activity apparently took place, as well as why deposit insurance for thrifts in particular turned out to be so disastrous. That reason was the virtual abandonment of capital standards by thrift regulators who not only formally lowered required capital-to-asset ratios in the early 1980s, but who also introduced new regulatory accounting principles (RAP) that effectively allowed failed thrifts to hide their insolvency. Romer and Weingast, as well as others, are also correct to point to the utterly senseless refusal by the Office of Management and Budget in the mid-1980s to increase the number of thrift supervisors precisely when they were needed most: that is, after the congressional decision in 1982 to broaden thrift asset powers. This action, too, had the effect of abolishing capital regulation for many thrifts.

It is now well recognized that the decision to let thrift operators play with federally insured deposits, but with little of their own money, was like throwing a lighted match into a pool of gasoline.[1] But it is less well understood that, by abandoning meaningful capital regulation, thrift regulators virtually invited high rollers and crooks into the industry. Had capital standards been enforced, few of the Donald Dixons (Vernon Savings and Loan of Texas), Charles Keatings (Lincoln Savings and Loan of Arizona), and David Pauls (Centrust Savings and Loan of Florida) would have ever bought thrifts.

In short, capital deregulation in my view lies at the bottom of the thrift disaster. But, then, this explanation too simply leads to another question. Why did thrift regulators, but not their bank counterparts, effectively gut

1. This point has now been so heavily discussed that one hesitates to single out any particular authors who have advanced it. Nevertheless, a small sample of the literature includes: Benston and Kaufman (1990), Brumbaugh, Carron, and Litan (1989), and Barth et al. (1985).

preexisting capital standards? Or, to put the question in somewhat more political terms, why did regulators and Congress wait for so long to put insolvent institutions out of business?

Romer and Weingast tells us that the answer is simple: Congress was behaving in a business-as-usual mode by encouraging regulatory forbearance, not only in now-celebrated particular cases (the Vernon and Lincoln S&Ls, for example) but in a systemic fashion by denying FSLIC sufficient funds to clean the insolvent institutions out of the industry.

Stripped to its essentials, the Romer/Weingast story is one we find over and over again in public policy circles. A narrow constituency, in this case the thrift industry, strongly wants a policy outcome, the costs of which are widely diffused throughout the economy. Congress then adopts the policy, in this case forbearance, largely by ignoring the problem and entrusting its resolution to its own narrow specialists, members of the banking committees.

Of course, Romer and Weingast tell a fuller story, embellishing it with an interesting econometric demonstration of the important role played not only by insolvent thrifts, who of course wanted forbearance in their own particular cases, but also by healthy thrifts, who feared that they would have to pay for the cleanup and thus encouraged their legislators to deny the thrift insurance fund of all the resources it required.

My only significant quarrel with Romer and Weingast is that by focusing so heavily on congressional and regulatory forbearance in the mid-1980s they provide an incomplete analysis of their topic—the "political foundations of the thrift debacle."

In fact, there were two stages to the thrift debacle of the 1980s, which, as Edward Kane (1989) has demonstrated, can be usefully analogized to a massive oil spill. Like the Exxon spill that dumped millions of barrels of oil onto the Alaska coastline, the first stage of the thrift crisis occurred when double-digit interest rates in the early 1980s caused thrifts to spill billions of dollars of red ink onto the financial landscape—by several estimates, over $100 billion in present value. But unlike the relatively rapid cleanup of the oil spill, the administration and the regulators did not ask for the funds, nor did the Congress voluntarily supply the funds, for cleaning up the initial thrift spill. Why?

Romer and Weingast do not directly answer this question—preferring instead to concentrate on later stages of the crisis in the mid-eighties—but the answers are straightforward. To have "cleaned up" the initial thrift spill would not only have cost far more money than anyone at the time was willing to spend, but it would have required the liquidation or assisted merger of most thrifts. At that time, few believed that effective substitutes for financing home ownership existed. The mortgage-backed securities market was growing, but it was not then as well developed as it eventually has become. In any event, even if all new mortgages could then have been securitized, it is highly doubtful that without some institutions dedicated primarily to buying those mort-

gages that they would have been fully absorbed by other buyers (pension funds, insurance companies and banks). All of these reasons help explain why Congress and regulators essentially chose to gamble on interest rates coming down, which eventually they did, rather than either shrinking the industry or, less radically, not permitting it to grow.

Nor do Romer and Weingast discuss in detail the political foundations of why the first thrift spill happened in the first place. Part of the answer, of course, lies in the Regulation Q deposit interest ceilings, whose origins could have been usefully explored. But Regulation Q applied to banks first, and, as I have already noted, banks did not get into nearly as deep a mess as thrifts in the 1980s. The reason, of course, is that banks have been free to invest in assets of varying maturities as well as to lend at floating rates.

In contrast, thrifts have been locked into long-term mortgages, which, until the early 1980s, had to be at fixed rates (except for certain state-chartered thrifts, such as those in California, that were permitted to extend adjustable rate mortgages in the 1970s). One of the great policy mistakes of the 1970s that Romer and Weingast should have given more emphasis was that Congress essentially refused to consider thrift industry proposals (as well as those of the industry's regulator, the Federal Home Loan Bank Board) to permit the extension of adjustable-rate mortgages: this would have dramatically reduced the magnitude of the initial thrift crisis of the early 1980s. By the logic advanced in the Romer/Weingast paper—wherein thrifts always get their way—this should not have happened. But it did because of heavy opposition from consumer groups.

The strength of the Romer and Weingast paper, as I have said, is that it focuses on what happened after the first thrift spill, or, using the oil spill analogy, why Congress and the regulators delayed cleaning up the initial thrift spill even after the "oil" turned toxic. Not only did thrifts have a single-minded interest in forbearance, but politicians could reasonably assume that there would be *no* immediate or near-term (two years for a Representative, or even six years for a Senator) costs to a forbearance policy. After all, depositors were protected against all losses, both by the formal deposit insurance system and, in the case of the larger thrift institutions, by the "too big to fail" doctrine implicitly developed by federal regulators when they protected uninsured depositors of Continental Illinois Bank in 1984. During the 1984–88 period, given the administration's adamant opposition to higher taxes, there also was little immediate or even intermediate-run prospect that taxpayers would suffer from forbearance. Finally, politicians could ignore warnings by the few economists, and eventually by FHLBB Chairman Ed Gray, that the FSLIC fund was effectively bankrupt by arguing that the problems thrifts were experiencing would be temporary. After all, had not the doomsayers who had pointed to the $100 billion-plus market value insolvency of the industry in the early 1980s been proved wrong by the subsequent drop in interest rates, which seemingly restored many thrifts to financial health?

Eventually, however, the toxic effects of the thrift spill became too large for even healthy thrifts and banks to ignore. Of course, by then the cleanup costs were also too large for them to pay, so with a free conscience they could presumably advocate a massive cleanup effort. But it is far from clear that this was why the Bank Board and then the new Bush administration finally began to attack the thrift problem with vigor. My simple-minded explanation is that eventually the press became convinced that the economists who had been warning about the immense magnitude of the problem had been right all along, which helped force the new administration into doing something major, at least after the 1988 Presidential election was over. In addition, by extending roughly $40 billion in government guarantees to buyers of failed thrifts in the 1988, Danny Wall (the chairman of the FHLBB at the time) also helped force Congress and the new administration confront the mess. The size of the expenditure, coupled with the off-budget way in which it was made, literally embarrassed both branches of government into going about the cleanup in a more straightforward way. As a reader I would have liked to have seen Romer and Weingast spend a little more time explaining why they think Congress and the administration backed off forbearance when they did.

Finally, I would have liked to see Romer and Weingast attempt to apply their logic to both predicting how, if at all, Congress will attempt to reform the system to prevent future "thrift spills." At a minimum, their paper persuasively suggests the broad outlines of what *should* be done.

We now know what happens when business-as-usual politics confronts a major crisis: defenders of the status quo will prevent an immediate solution to the problem as long as no one feels the costs of not addressing it (or the costs of not doing so are diffused broadly throughout the population). Armed with this knowledge, it surely makes sense to develop mechanisms for forcing much earlier action to be taken when depository institutions get into trouble, but *before* they become insolvent.[2] One possible approach is to require regulators to intervene early and to base their judgment on more realistic market-based measures of the financial condition of institutions (Benston et al., 1989). A supplement, or alternative, is to rely more heavily on market mechanisms, whether discipline by depositors, holders of subordinated debt, or private deposit insurers.

I realize this is not the forum in which to debate the relative strengths and weakness of these alternative proposals. The concluding question that I would like to raise here is, What do Romer and Weingast believe their political analysis has to say about which, if any, are likely to be adopted? My own forecast,

2. Earlier action would surely mitigate losses to the insurance funds. In the 1980s the FDIC lost approximately 12 cents per dollar of recorded assets on failed banks. Since 1986, the thrift insurance fund (first the FSLIC and then later the Savings Association Insurance Fund of the FDIC) has lost more than 30 cents per dollar. These loss figures demonstrate that, by the time the capital of a depository institution, measured at book value, falls below zero, the market value of the institution is far less than that.

based on my inside-the-Beltway knowledge and intuition, is that, first, given the huge dimensions of the thrift problem and the certainty that more money will have to be authorized to solve it, Treasury will recommend and in 1991 or 1992 that Congress adopt significant reforms in deposit insurance. These will include: (1) authority for the FDIC to introduce risk-sensitive pricing of deposit insurance premiums; (2) some variation of the American Bankers Association proposal requiring mandatory "haircuts" on uninsured deposits; and (3) authorization for regulators to assume conservatorship of troubled depositories before they become insolvent.

Without discussing the merits of any specific proposal, I believe that, in combination, the set of reforms I have just described would force regulators to act much earlier than they do now to assume conservatorship or to force the merger of troubled depositories. I hope that Romer and Weingast in their future work lend their considerable talents to forecasting whether the political system that brought us the thrift crisis can ever help prevent another, and, if so, how.

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