EVERYBODY'S BUSINESS

By David Kotz

S&L hell: loan wolves howl all the way to the bank

By David M. Kotz

We've grown accustomed to learning about economic problems that keep getting bigger. The budget and trade deficits of the '80s came to public attention as large, scary numbers were announced. And those numbers were soon replaced by a series of much bigger numbers as both deficits rose rapidly.

This familiar process of rapid escalation of the dollar size of a crisis produces a numbing effect. How can one get upset at the current estimate of the size of a problem when it will probably soon be doubled or tripled?

The saving and loan association (S&L) crisis is perhaps the most extreme example of this syndrome. In March of 1986 Edwin Gray, then chairman of the Federal Home Loan Bank Board (FHLBB), warned that resolving the S&L crisis would cost $16 billion. In December, 1987 the new chairman of the FHLBB, M. Danny Wall, estimated a $17.4 to $22.7 billion cost. Seven months later he upped it to $30.9 million and three months later, in October of 1988, to $45-50 billion.

Bailout bonanza: The Bush administration's S&L bailout bill, sent to Congress in February of this year, placed the price tag at $126 billion. Three weeks later, the administration raised the cost estimate to $157.6 billion. Of this latest estimate, $135 billion represents the funds required to bail out the depositors of insolvent S&Ls, with the remainder largely going to pay interest on bonds sold to raise the funds needed. Some experts warn that the total cost could go as high as $200 billion. In three years, the official estimate grew nearly tenfold. (By comparison, the combined cost of the past public bailouts of PennCentral, Lockheed, New York City, Chrysler, Continental Illinois National Bank and the Farm Credit System came to $18 billion.)

Many commentators warned that the federal budget deficits and trade deficits would cause the sky to fall. The fact that it has not might lead to complacency regarding the current headline-grabbing debt crisis, but that would be a mistake. While the budget and trade deficits are serious problems, they do not represent debts that Americans are likely to have to pay back any time soon, or even in the future. But the S&L bailout cost will indeed have to be paid, with most of the burden likely to fall on the taxpayers. The Financial Democracy Project, a coalition pressing for a progressive solution to the crisis, has estimated that the proposed bailout could cost taxpayers as much as $1,000 per household on average.

How did this enormous crisis develop? How did it grow so rapidly? Where did the countless billions in depositors' money, which the S&Ls no longer have and the taxpayers are now asked to repay, end up?

Home-loan history: Savings and loan associations developed in the early 19th century as specialized financial institutions that took in small savings deposits and lent money to enable people to buy a home. Until recently S&Ls were all "mutuals," meaning they were owned by their depositors rather than profit-seeking shareholders. Along with other financial institutions, they suffered from the stormy course of American financial history up through the Great Depression.

In 1933-34 the wave of New Deal legislation that created a new regulatory system for commercial banks also set up a system for the S&Ls. The Federal Home Loan Bank Board (FHLBB) was given regulatory authority over S&Ls, and the Federal Savings and Loan Insurance Corporation (FSLIC) was created to insure S&L deposits. This regulatory apparatus helped establish stable institutions to provide financial resources for homeownership.

After World War II the system—supplemented by other federal programs to steer financial resources into housing—worked reasonably well. Millions of Americans got mortgages on favorable terms. From 1950 through 1970, 31 million housing units were built, including 20 million single-family homes. The percentage of owner-occupied housing units rose rapidly from 43.6 percent in 1940 to 61.9 percent in 1960, then inched up through 1980 to 64.4 percent.

S&Ls provided the bulk of the mortgage financing for this vast expansion of homeownership and grew rapidly during this period. In 1945 S&L assets were less than 5 percent as large as commercial bank assets, but by 1965 they had grown to 39 percent as large as the commercial banks. Despite the rapid expansion, the life of an S&L was tranquil. The roughly 5,500 S&Ls took in deposits through passbook savings accounts paying low interest rates and lent most of the deposit money out for home mortgages in their local area at rates 2.5 to 3 percentage points over the rate they paid their depositors. The difference covered the S&Ls' administrative costs. Failures were almost unknown among S&Ls through the mid '60s, and the few that occurred were associated with criminal activity.

Federal regulations insured S&L deposits regardless of an institution's financial condition. This prevented the fear-driven runs on S&Ls that had closed healthy institutions as well as ailing ones in the past. S&Ls' lending activities were limited to such safe areas as home mortgages and government securities. The regulatory authorities set interest rate ceilings to effectively keep S&L deposit rates at a level slightly above the commercial bank rate. The regulators set the deposit rates at a level that would assure an adequate spread between mortgage and deposit interest rates, thus assuring that well-managed S&Ls would remain healthy.

From stability to crisis: The smooth working of the S&Ls was not isolated from the rest of the economy. From the mid '40s to the late '60s, the American economy as a whole had only mild ups and downs. Despite conservative politicians' constant warnings, there was little inflation and low interest rates promoted rapid economic growth.

In the late '60s conditions began to change, as the economy entered what would turn out to be a long period, not yet over, of instability and stagnation. Inflation began to rise, and in the '70s it became a major problem. With it came rising interest rates as lenders demanded higher rates to compensate themselves for the depreciation of the value of their loans caused by inflation. From 1950 to 1965 interest rates on 3 month treasury bills varied between 1 percent and 4 percent, but from 1966 to 1979 these rates ranged as high as 10 percent.

The high interest rates threatened to undermine the ability of the S&Ls to obtain deposits. People getting 5.25 percent interest on their savings heard about the high money market rates and wondered why little folks couldn't get such rates. Wall Street saw a profit opportunity, and Money Market Mutual Funds (MMMFs) were born. Beginning in 1972, they allowed middle-income savers to buy shares, the proceeds of which were invested in large denomination securities that paid high money market rates. As MMMFs expanded during the late '70s, people made large withdrawals from savings and loans, a process known as "disintermediation."

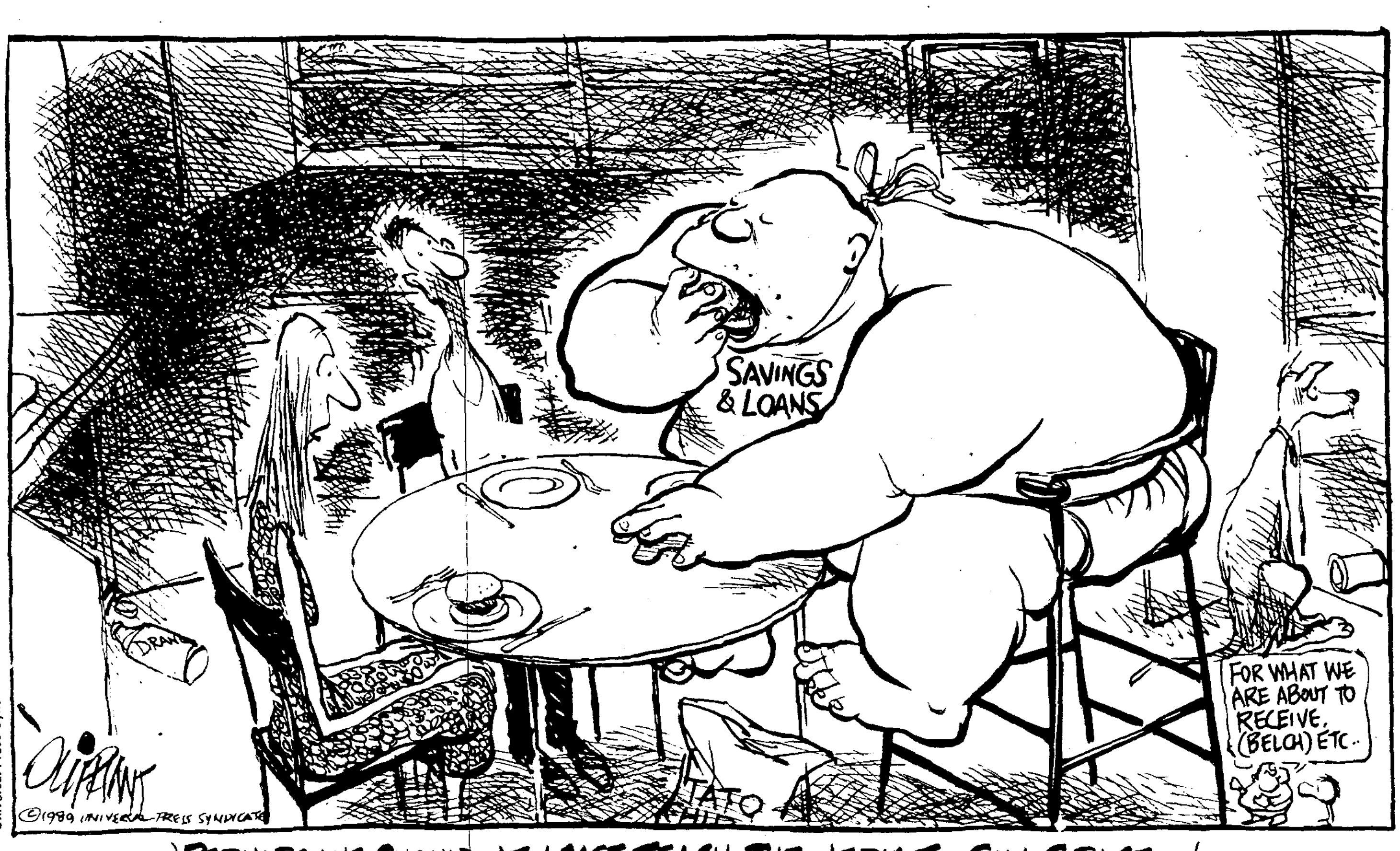
The regulatory authorities' response contained the seeds of worse disasters ahead. To allow the S&Ls to compete with the MMMFs, in 1978 they authorized S&Ls to issue 6-month money market certificates paying rates slightly above the 6-month treasury bill rate. This helped stop disintermediation, but at a price. The S&Ls' cost of obtaining funds, previously kept low by regulation, now began to rise with the money market rates. S&Ls income, however, came from long-term, fixed rate mortgages. Thus, the S&Ls' income rose only slowly as old mortgages were paid off and new ones were made at higher rates, while their costs of funds rose rapidly. This squeeze helped set off the '80s S&L crisis.

The crisis began in two stages. From 1979 to 1982 regulatory changes and actions plus economic recession created hundreds of insolvencies among S&Ls. Then in the mid-'80s, the problem worsened as the economy of the Southwest collapsed.

A fateful summer: In the summer of 1979 a decision was made that would have fateful consequences. Under intense pressure to rein in inflation and stabilize the dollar in international currency markets, President Carter named Paul Volcker, the international banking community's choice, to head the Federal Reserve System. In October of that year, Volcker made a radical change in monetary policy. Giving up the past practice of stabilizing interest rates, the Fed sharply contracted the supply of money and credit, driving interest rates up to the highest levels of this century.

By 1981 the prime lending rate had reached 21.5 percent. The high interest rates attracted foreign capital into the country, restoring the international value of the dollar. And, by plunging the economy into the deepest recession since the '30s, it broke the back of the inflation process, as the inflation rate fell below 4 percent in 1982.

The Fed-induced astronomical interest rates hit the S&Ls just as a second government innovation was arriving: financial de-



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'PERHAPS WE SHOULD AT LEAST TEACH THE JERK TO SAY GRACE...'

regulation. This development derived from three main sources. Mainstream economists had been pressing for the reduction or elimination of many government regulatory programs for some time, believing that unregulated markets bring superior efficiency and faster growth. Conservative ideologues were arguing that big government was the root of our economic problems. And the big banks lobbied hard for loosening the regulation of financial institutions, which would enable them to gobble up a bigger share of the financial services business.

A confluence of interests: This confluence of forces led to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the followup Garn-St. Germain bill of 1982. These bills phased out interest rate ceilings and allowed S&Ls more leeway to engage in commercial real estate lending and commercial loans, and to invest in risky debt securities. They were allowed to raise funds through expensive "brokered deposits," which are large deposits that brokers place in whatever S&L will pay the highest rates. At the same time, several states, including Texas, California and Florida changed their laws to allow state-chartered S&Ls to invest in a still-wider array of projects, including direct investments in commercial real estate. It was claimed that these changes would enable S&Ls to obtain funds in the current high rate markets and to find uses for those funds that would pay even higher rates.

Deregulation combined with sky-high interest rates meant that the S&Ls' cost of obtaining funds went up and up. In 1980 S&Ls had to pay an average of 8.8 percent for funds, in 1981, 10.9 percent and in 1982, 11.2 percent. While new mortgage rates rose in those years, the S&Ls' inventory of older fixed-rate mortgages kept the average return on mortgages below the cost of funds. For three years the S&Ls were paying more to obtain funds than they were getting from their mortgage loans. The S&Ls lost $4.6 billion in 1981 and $4.1 billion in 1982. These loses were so large not just because of the negative rate spread, but also because the severe recession of 1981-82—largely due to the same Fed-induced high interest rates—caused many loan defaults.

The huge losses of 1981-82 weakened nearly all S&Ls, and some became insolvent. Only 17 S&Ls were insolvent in 1980, but the number rose to 65 in 1981 and 201 in 1982. The assets of insolvent S&Ls grew from $127 million in 1980 to $49 *billion* two years later. By 1982 institutions having net worth at the dangerous level of 3 percent of assets or less held 36.9 percent of all S&L assets. The S&L crisis had arrived.

Regulatory response to the crisis: In 1980-82 the FSLIC faced a crisis as its own insurance reserve fund was drawn down by the need to close or subsidize the acquisition of many insolvent S&Ls. In 1982 the FSLIC had to spend $2.4 billion to close or merge ailing S&Ls. The FSLIC insurance reserves, built up from mandatory S&L payments, dwindled from about one percent of insured S&L assets in 1980 to three-quarters of one percent in 1983. (As the crisis worsened, the insurance reserve disappeared. The FSLIC itself became insolvent in 1986.)

The regulatory authorities responded with short-sighted measures to reduce pressure on the S&Ls. Accounting standards were eased to permit S&Ls to look healthier than they actually were. The minimum required net worth for S&Ls was reduced from 5 percent of assets to 3 percent during 1980-82. Conversion from the mutual form to stock corporations was encouraged as a way to raise additional net worth capital, and by 1984 a majority of S&L assets were held by corporate S&Ls. Regulatory authorities supported the legislative easing of restrictions on S&L loans and investments. All of these actions made the problem grow worse over time.

But most disastrous was the regulatory authorities' decision to stop closing insolvent S&Ls. Realizing that the FSLIC insurance reserve was inadequate to continue closing the growing number of insolvencies, the authorities simply stopped closing most of them. It was hoped that the greater freedom of action possessed by the deregulated S&Ls would enable them to work their way back to solvency. After 1982 the number of closings and other interventions dropped sharply, while the number of insolvencies kept growing.

As insolvent S&Ls began to realize that they were not likely to be closed in the immediate future, a perverse process set in. The owners of insolvent S&Ls, having already lost their capital investment, had nothing to lose from adopting a strategy of rapid expansion by obtaining high-cost funds and investing them in risky but potentially high-yielding loans and investments. It was a "heads I win, tails you lose" strategy. If the risky investments succeeded, the S&L would return to solvency, and the owners would reap a big profit. If they failed, the FSLIC would have to bail out the depositors, and the owners would be no worse off.

Some long-established S&Ls embarked on risky expansion programs. And sharp operators, particularly in Texas and California, saw big opportunities in this situation. They moved in to buy insolvent S&Ls, which could be purchased cheaply if they were stock associations, gaining the opportunity to use federally insured deposit money for speculative investments. Even many financially healthy S&Ls were swept up in this speculative fever. The original mission of S&Ls was forgotten as the share of S&L assets put into home mortgages fell from nearly 60 percent in the early '70s to 40 percent in 1984 and 30 percent in 1988. The percentage of all residential mortgage funds provided by S&Ls fell from 44.6 percent in 1977 to 26.9 percent in 1987.

In Texas and the rest of the Southwest, S&Ls poured funds into risky commercial real estate development. It seemed a good bet in the early '80s, after the second big oil price hike in 1979 pumped prosperity into the oil region. But when oil prices fell from 1984 to 1986, the Southwestern economies fell with them, causing real estate markets to collapse. The high-flying S&Ls lost their gamble. The "tails you lose" side came up, with the "you" being the FSLIC, and ultimately the taxpayers.

The costs of delay: The long delay in dealing with the mounting S&L crisis greatly increased its magnitude. If an initially healthy S&L begins to lose money, its net worth (assets less liabilities) declines. If the regulatory authorities had perfect timing and could close the institution at the moment its net worth hit zero, there would be no costs apart from some administrative ones. With zero net worth, the proceeds from the sale of the assets would just cover the debts of the S&L, including the depositors' claims.

The S&L crisis grew so large because the FHLBB failed to promptly close or merge insolvent institutions. After the FSLIC itself became bankrupt, the regulatory authorities delayed going to Congress for additional funds. By knowingly allowing insolvent institutions to stay open, they greatly increased the cost of resolving the crisis as most of the insolvent S&Ls kept losing money. Not until August 1988 did the authorities aggressively move to close or merge the insolvent S&Ls.

The Reagan administration didn't want to stir up this hornet's nest out of fear of hurting Bush's election chances. For some reason the Dukakis campaign failed to make it an issue. A realistic bill to finance a complete resolution of the crisis was not introduced until Februrary of this year. Representative Charles Schumer (D-NY) of the House Banking Committee estimates that every day of delay adds $30 million to the eventual taxpayer cost as S&L losses continue to mount.

A crooked mile: Theft and fraud by S&L officials also played a role in the crisis. The Federal Deposit Insurance Corporation recently announced finding criminal activity at almost half of 220 insolvent S&Ls that it investigated. FHLBB officials last year claimed that evidence of fraud or criminal conduct was found at 75 percent of the insolvent S&Ls.

Deregulation and the absence of effective oversight explain why criminal activity became widespread. Starting pay for FHLBB examiners averaged about $14,000 in the early '80s, far less than for commercial bank examiners. This produced a high turnover of examiners. And pleas for more funds to hire more examiners as the crisis developed went unheeded by the Office of Management and Budget. As S&L executives at pressured institutions realized how lax the oversight was, the temptation to skirt the law became overpowering in many cases.

Clearly, public regulation and unbridled competition are a dangerous combination. No major nation leaves the provision of financial services to the unregulated market. There were sound reasons for creating a strong public regulatory system for the S&Ls in the '30s. The safeguarding of people's hard-earned savings cannot be left to unregulated, profit-seeking institutions.

On the other side of the ledger, the flow of financial resources into the production and purchase of housing cannot be left to the market. If society is to assure everyone a decent home, publicly regulated institutions must see to it that funds are made available for this purpose at an affordable cost. The S&L industry, in its days of full regulation, made some progress toward accomplishing these objectives, providing a safe repository for savings and placing them in home mortgages.

The '80s financial deregulation was based on the premise that competition and profit maximization is the best way to organize the financial sector. Warnings that competition and profit-seeking produce risks and failures were brushed aside. While investors in ordinary businesses may be willing to risk loss of their investment, people who place their savings in the local S&L do not want to risk their loss. This requires federal insurance. But telling the S&Ls to compete and go for maximum profits means they must risk the depositors' funds. And with the depositors' claims backed by the government, a distorted incentive structure is created that pushes the S&L owners to take excessive risks, knowing that failure will bring a federal bailout.

Many factors contributed to the size of the S&L collapse. But the fundamental problem was the misguided attempt to mix competition with public regulation. The outcome of this mixture is captured by the convenient availability of automatic teller machines, introduced rapidly due to the spur of competition—but that same spur of competition has wiped out billions of dollars of funds that depositors would now be unable to withdraw, automatically or otherwise, were it not for the federal insurance guarantee.

Where did the money go? The $157.6 billion estimate of the bailout cost includes, in addition to interest payments, $135 billion in direct bailout costs. That represents the difference between depositors' federally insured claims and what the government thinks it can extract from the assets of the problem S&Ls, either by selling off assets or arranging subsidized mergers. Where did the missing $135 billion go?

There are four main places the money went. First, some went to line the pockets of thieves. Some S&L officials illegally used company resources for personal consumption. For example, a lawsuit charged that Vernon Savings and Loan of Texas bought a $2 million California beach house for its chief executive, Don R. Dixon, and paid for furnishings and living expenses of $800,000 a year, including $36,780 for flowers. Other S&Ls made big loans to associates of the officers with no expectation of being repaid. While the individuals responsible for such criminal activity can be prosecuted, the misappropriated funds generally are unreachable since they have long since been spent for luxury consumption.

Second, the money went to finance failed commercial construction projects. All over the Southwest stand shopping malls and other commercial developments that went bankrupt with the oil bust.

Third, money was lost through speculation of various forms. Some S&Ls bought and sold real estate and securities, hoping to make a profit. Instead of buying cheap and selling dear, most did the reverse. The money went to other market participants who succeeded.

The fourth place the money went involves a more subtle process. The initial blow to the S&Ls was struck by Federal Reserve Chairman Paul Volcker when the Fed raised interest rates through the ceiling from 1979 to 1981. Indeed, interest rates have remained very high by historical standards ever since. These high interest rates imposed huge losses on the S&Ls from 1980 to 1982, eroding their net worth and pushing hundreds into insolvency.

This process caused a major redistribution of income in the U.S. Between 1972 and 1982 the share of interest income in total national income doubled from 5.4 percent to 10.8 percent. This represented an enormous transfer of income from the great majority to the small part of the population that has substantial net financial assets. Those who put money into S&Ls in those years in large denomination, high-yielding money market certificates, brokered deposits and so forth received a rate of return far above what homeowners were paying on their mortgages, thus siphoning off the S&Ls' net worth. Hence, part of the money lost went to wealthy moneylenders, thanks to the Fed's high interest rate policy. ■

VIEWPOINT

The new homeless: America's drifting corporations

By Milton Moskowitz

THERE'S NOTHING LIKE YOUR OWN HOMEtown. No matter where you may end up living, the place where you were born and/or grew up will always have a special meaning for you—and it's that way for many companies too. Ford Motor Company is headquartered in Dearborn, Mich., 10 miles outside Detroit, because that's where Henry Ford was born and grew up. Hershey is located in Pennsylvania Dutch country, 30 miles from Lancaster, because that's where Milton Hershey was born and grew up. And Levi Strauss is headquartered in San Francisco, not far from the dock where Levi Strauss arrived in 1850.

Of course it's more difficult for conglomerates to have this sense of roots. Being a hodgepodge of different entities, they can have many hometowns. Consider, for example, RJR Nabisco, which recently went private in a $25 billion leveraged buyout engineered by Kohlberg Kravis Roberts (KKR).

Tobacco roots: The main engine of RJR Nabisco is R.J. Reynolds Tobacco, the nation's second-largest purveyor of cigarettes. Reynolds has an association that goes back more than 100 years with the principal tobacco-growing state, North Carolina. In fact, it took two of its major brand names from its headquarters city, Winston-Salem.

Richard Joshua Reynolds, the founder of the company bearing his name, used to foster the legend that he first rode into the twin hamlets of Winston and Salem in the Piedmont region of North Carolina as an illiterate, barefoot farm boy atop a wagon load of his dad's tobacco. To visit Winston-Salem is to be overwhelmed by the tobacco culture that permeates the region. And Reynolds has been a central fixture in that culture throughout this century. The 22-story Reynolds Building that went up in Winston-Salem in 1929 was then the largest building south of Baltimore. It was also the model for the Empire State Building, which went up in New York in 1931. The same architect, William Lamb, designed both structures.

R.J. Reynolds became one of the largest contributors to independent colleges and universities, especially those in the South. In 1956 it was instrumental in having Wake Forest University relocate from Wake County, N.C., to Winston-Salem. During the '60s, when many cities—including Winston-Salem—were racked by riots, Reynolds put up $1 million to fund the establishment of a Winston-Salem citizens' coalition to improve housing and public transportation.

After research linking smoking to lung cancer was accepted by the U.S. Surgeon General in 1964, Reynolds, flush with profits from cigarettes, diversified into foods, wine and liquor, container shipping and oil exploration. One of the biggest acquisitions, in 1979, was San Francisco's Del Monte. And once it became part of Reynolds, Del Monte was never again to play the role it once did in its hometown. The shots were being called from Winston-Salem.

In 1985 Reynolds—by now called R.J. Reynolds Industries —pulled off its biggest acquisition, absorbing Nabisco Brands, itself the result of a 1981 marriage that united Nabisco (Ritz crackers, Geritol, Oreo cookies, Wheat Thins, Shredded Wheat) with Standard Brands (Planters nuts, Fleischmann's margarine, Blue Bonnet margarine, Royal puddings). The company changed its name to RJR Nabisco—but the headquarters remained in Winston-Salem.

Corporate weaning: The unthinkable—to Winston-Salem—happened in 1987 when RJR Nabisco decided to get out from under this tobacco wrap and move the headquarters of the corporation to Atlanta. It made sense, they said, to have RJR Nabisco "assume the role of a holding company, a separate parent company." And of course parents don't live with their children anymore. Besides, in moving to Atlanta, at least they weren't deserting the South.

However, now that RJR Nabisco has became a ward of KKR, taking on a mountain of debt to finance the buyout of the public shareholders, the corporate address is going to change again. Strike Atlanta from the letterhead and substitute New York City or a suburb of New York. The new headquarters will definitely be in the New York area. It's not certain yet how many of the 450 Atlanta headquarters people will be making this move. RJR Nabisco is in a cost-cutting mood—and layoffs are expected.

Hardly anyone moves anymore from Atlanta to New York. But of course this move has a certain amount of logic to it. First of all, the new chairman and chief executive of RJR Nabisco is Louis Gerstner Jr., formerly president of American Express. Gerstner lives in Greenwich, Conn. This way he won't have to pull up stakes and look for a condo in Atlanta. But a more important reason is the highly leveraged position of RJR Nabisco. It has something like $23 billion of debt on its books—and the pieces of paper representing this debt were bought and sold by New York investment bankers. When you owe so much money, it's a good idea to keep in close touch with the peole who lent it to you. Gerstner had a euphemistic way of putting it:

"The objectives of our parent company can best be achieved by maintaining close, ongoing contact with the investment banking community and other New York-based segments of the business community."

So forget about Camel cigarettes and Oreo cookies and Del Monte fruit cocktail and the plant communities where these products are turned out. We're talking about important money here. That's priority No. 1. RJR Nabisco's new hometown, fittingly, is Wall Street. ■

Milton Moskowitz has published widely on business and corporate affairs.