ETHICAL CONFLICTS IN MANAGING THE S&L INSURANCE MESS
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ABSTRACT

Taxpayers losses in the S&L insurance mess were manufactured in Washington. Taxpayer losses had little to do with the nature of the S&L business. Taxpayers lost money --not because federally insured S&Ls lost money-- but because elected and appointed officials systematically mishandled S&L losses. For several decades, officials unethically covered up S&L losses and denied that these losses were progressively undermining the solvency of the Federal Savings and Loan Insurance Corporation (FSLIC). Authorities used this informational cover to delay indefinitely the recapitalizations of hundreds of economically insolvent “zombie” S&Ls. From at least 1975 on, the proliferation of living-dead insured S&Ls distorted funding and investment decisions throughout the deposit-institution industry. Distorted decisionmaking compounded S&L losses until the red ink passed through the books of FSLIC onto the books of taxpayers on a massive scale.

The paper develops a hypothetical case for indicting top regulators, members of Congressional banking committees, and presidents who served between 1975-1988 on three charges of unethical behavior:

1. fraud
2. influence peddling
3. gambling at imprudent odds with taxpayer money.

The paper concludes with an analysis of how to change managerial incentives in public service to avoid future deposit-insurance debacles.
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With the benefit of hindsight, most observers agree that taxpayer losses in the S&L insurance mess exceed $150 billion and resulted from a pattern of industry losses, expedient policy mistakes, and taxpayer ignorance and unconcern about the size and significance of losses and mistakes alike. Assessing blame for this mess reduces to a pair of tasks: identifying the damaging mistakes and assigning responsibility for them.

The first task is a straightforward investigative chore: finding out what actually happened and determining the extent of the damages. Assigning blame is more complex. It entails analysis that turns on whether to benchmark right conduct by means of a relative or an absolute ethical standard.

Even though it accords situational managerial ethics informal standing, common law employs an absolute ethical standard for assigning responsibility for the S&L insurance mess. This massive body of centuries-old case law presumes accountability for actions that harm others and treats conduct as morally wrong whenever it is violative of duties of loyalty and care legitimately owed to others. Because the duties a manager owes to different parties must regularly be traded off against each other, this standard is difficult to apply in practice. Thus, accountability for damages done to various stakeholders must be thrashed out case by case in the courts.

A relative standard is endorsed by Jackall, who documents that operative principles of managerial and professional ethics often conflict with the ideals of academic and churchly moral codes. He defines managerial ethics disarmingly as rules that “managers construct to guide their behavior at work” (Jackall, 1988, p. 4). The morality of these rules, he says, “does not emerge from some set of internally held convictions or principles, but rather from ongoing albeit changing relationships with some person, some
coterie, some social network, some clique that matters to a person” (Jackall, 1988, p. 101). In large organizations, “independent morally evaluative judgments get subordinated to the social intricacies of the bureaucratic workplace” (Jackall, 1988, p. 105). An avowed goal of these intricacies is to “nurture the trust required to maintain a kind of corporate nonaccountability for expedient actions” (Jackall, 1988, p. 118).

Whenever they are accused of policy mistakes, government officials lean on their Jackallian ethical code to spin to a series of well-worn, but contradictory defenses:

1. The policy actions in question cannot be characterized fairly as importantly damaging anyone.
2. The alleged mistakes serves a far-higher goal, for whose achievement officials should be celebrated, not chastised.
3. Nobody knows who made the mistakes nor perhaps even when or why they were made.
4. Nobody can prove who made the mistakes or why they made them.
5. One member of the team is ultimately responsible and deserves to be sanctioned.
6. Sovereign immunity means never having to say you are sorry.

Although all of the first five excuses were sounded by various officials at different times during the course of the S&L mess, this essay argues that the sixth defense --that no one was meant to be accountable for the expedient policies that compounded taxpayer losses--is the only persuasive one. The ethical analysis presented here relies upon the legal ethical standard.

I. Incentive Conflict in Government Service

In the S&L insurance mess, the fundamental step in assigning blame is to distinguish the causes of S&L losses from the causes of taxpayer losses (Kane, 1989). The causes of losses at individual S&Ls can be personified as gangs of miscreants that informed witnesses need in each instance to identify from a lineup of the “usual suspects” that competent investigators would round up to lay blame for the failure of any regulated enterprise. These suspects are: bad economic luck, bad (meaning either poor or
dishonest) managers, bad (meaning perversely unrealistic) theories of regulation, bad accounting for losses in deposit institutions, and bad faith by public officials.

On the theory offered here, the loss-intensifying role played by the last factor is critical to harm passing through to taxpayers. We allege that expedient behavior by public officials helped to provoke --and served to compound-- the damage initiated by the usual suspects. We see the root problem that caused extensive taxpayer losses as a breakdown in ethics of delegation: an insufficient ability to monitor and police incentive conflicts between taxpayer “principals” and their government-employee “agents.”

In a representative democracy, taxpayers delegate tasks to elected and appointed government officials. As in any other delegation, important conflicts of interest stand between taxpayers and their agent government officials. An ideal principal-agent relationship exists when an agent intends to offer its principal a selfless application of time, energy, expertise, and information. These ideals are stated in academic and churchly moral codes, but belittled in the accountability-resistant codes of Jackallian managerial ethics.

Economics tells us that costs from principal-agent conflict (“agency costs”) are minimized when society’s institutions weave a web of so-called “optimal contracts” that align the incentives of the agent with interests of the principal or whenever ethical constraints to which agents voluntarily and scrupulously subscribe inadvertently happen to minimize the costs of principal-agent conflict. Conflicts between government managers’ opportunities for personal enrichment and advancement and the simpler joy of doing a task honestly and proficiently explain the two key features of the S&L mess: (1) why so many S&Ls and banks were allowed to become so severely wrecked and (2) why the bill for repairing the damage ended up on taxpayers’ tab.

For managerial markets to work well, enough information must flow to permit accurate external evaluation of a manager’s job performance. This paper speculates about whether violations of informational reporting and other duties owed to taxpayers by government officials might --in the absence of sovereign immunity-- be provable in court. It asks readers to decide for themselves whether flows of disinformation about policy-
making mistakes resulted predominantly from innocent errors or were the fruit of
deliberate violations of express or implicit truth-telling obligations that responsible
officials owed to taxpayers and that taxpayers ought to concern themselves with enforcing
in the future.

In government service, only limited opportunities exist for outsiders and markets
to challenge self-assessments of the quality of bureaucratic enterprise and worker
performance. Inside whistleblowing from individuals who may be distressed about what
they perceive to be serious deviations from the social mission of their agencies is
discouraged by the threats of career and reputational reprisal. For both reasons, watchdog
agencies such as the General Accounting Office, Civil Service Commission, and the
General Services Administration are charged with monitoring and enforcing merit
systems of performance measurement and contracting. In turn, these oversight agencies
are themselves answerable to high elected officials, academia, and the press. Finally,
elected officials are accountable to the electorate.

In a representative democracy, this web of rules, enforcement, and accountability
sets minimum responsibilities for all parties. Once these minimal standards have been
clearly defined, derelictions of duties can be measured quasi-objectively as departures
from them.

This essay concerns itself with violations of standards for truth-telling and faithful
service that common law suggests ought to have been applicable to the high officials that
were charged closely with managing or overseeing the operations of the Federal Savings
and Loan Insurance Corporation (FSLIC). It maintains that decades of covering up bad
news worsened the true economic condition of FSLIC and the S&L industry. This long-
lasting accounting coverup greatly compounded the damage suffered by taxpayers. It did
this by allowing losses in S&L enterprises to accumulate beyond the value of private
ownership stakes, so that red ink slowly and surreptitiously spilled onto the books of
FSLIC and through FSLIC onto the tab of ordinary taxpayers.

The behavior of high officials during the S&L mess recalls Christ’s Parable of the
Unjust Steward. Historically, a steward was an official in the household of a king or
other noble who was responsible for managing the servants, household income and expenditures, and inventories of household provisions. He transacted all legal and financial business for his lord, who (as a noble) shunned commercial activity.

There was a rich man that had a steward, and a report came to him that this steward had wasted his goods. Whereupon he sent for him, and said to him, What is this I hear of thee? Give an account of thy stewardship, for thou canst not be my steward any longer. At this, the steward said to himself, What am I to do, now that my master is taking my stewardship away from me? I have no strength to dig; I would be ashamed to beg for alms. [Aha!] I see what I must do, so as to be welcomed into men’s houses when I am dismissed from my stewardship. Then he summoned his master’s debtors one by one; and he said to the first, How much is it that thou owest my master? A hundred firkins of oil, he said; and he told him, Here is thy bill; quick, sit down and write it as fifty. Then he said to a second, And thou, how much dost thou owe? A hundred quarters of wheat, he said; and he told him, Here is thy bill, write it as eighty. And this knavish steward was commended by his master for his prudence in what he had done; for indeed, the children of this world are more prudent after their own fashion than the children of the light... No servant can be in the employment of two masters at once; either he will hate the one and love the other, or he will devote himself to the one and despise the other. You must serve God [your principal] or money [Mammon: i.e., your own narrow welfare]; you cannot serve both. [The Gospel According to Luke, Chapter 16, verses 1-8 and 13, as translated by Ronald Knox, 1944.]

The parable frankly acknowledges every agent’s natural tendency to be more sensitive to its rights than to its duties. It treats the loss suffered by the landowner as just punishment for his lack of diligence in monitoring the behavior of a steward whose incentives he had severely distorted by giving notice of imminent dismissal. That the
landowner recognized his negligence is shown by his admiration for the steward’s ingenuity in transferring wealth from the landowner during the steward’s eventful final day of service.

Just as the landowner, U.S. citizens have failed to demand from their managers the information they need to protect themselves from unjust stewardship. U.S. taxpayers have been willing to settle for a flow of half-truths that lack the power to shame poor performers when bad faith is uncovered. Too many citizens apathetically accept corruption and moral cowardice in public officials as nuisances that must be accepted, rather than as evils for which society ought to design reliable procedures to discourage and punish.

II. Hypothetical Indictment Proceedings

Throughout this section, I ask readers to pretend that I am a prosecutor and that they are members of a grand jury. Our joint task is to use common and statutory law to conduct an inquiry into the ethics of a series of linked corporate, bureaucratic, political, and taxpayer behaviors in the S&L industry.

This inquiry is merely hypothetical because courts might conclude that elected and appointed officials charged with supervising and managing the affairs of FSLIC enjoy sovereign immunity for their actions. Such immunity is rooted in the ethically questionable proposition that a monarch or high official in a sovereign state should have absolute freedom in making and enforcing the laws of the land. To protect officials from being compelled to spend much of their lives in court, wielders of sovereign power are exempt from conventional burdens and civil liability for most of the actions they take.

But let us pretend that another tribunal has authorized us to weigh indictments for three separate breaches of the duties of trust and public stewardship that elected and appointed officials owe to taxpayers:

a. fraud
b. influence peddling
c. gambling imprudently with taxpayer money.

a. Fraud
Five cumulative common-law tests must be met to bring a fraud indictment (Bear and Maldonado-Bear, 1994):

• a conscious misrepresentation or concealment of the truth
• an intent to benefit by causing another party to rely on the untruth to his or her detriment
• the misrepresentation was material (i.e., directly related to the harm caused)
• an intent to cause the other party to rely on the misrepresentation to his or her detriment
• evidence exists that the other party did believe, rely, and suffer provable harm.

I am going to ask readers to consider the applicability each of these 5 tests to members of Congressional Banking Committees, to presidents, and to members of the regulatory braintrust of the FSLIC who held office during 1975-1988. In voting, readers must remember that, to bring an indictment, the standard of guilt is “probable cause.” This standard requires only that the possibility of guilt constitutes a reasonable inference based on “credible evidence.” It does not require us to ascertain “guilt beyond a reasonable doubt.” This tougher standard would take extensive investigative work and weeks of trial to establish.

First Test. Did misrepresentation occur in the ways in which top officials accounted for FSLIC’s loss exposure in the decades prior to its demise in 1989? Were accounting smoke and mirrors used to cover up loss exposures officials knew or should have known FSLIC was accruing?

Tables I and II present figures to show that authorities knew or should have known of FSLIC’s longstanding weakness. For top regulators, the force of these figures is confirmed in part by testimony from economist Lawrence White, who knew (White, 1991, p. 141) as a member of the Federal Home Loan Bank Board (FHLBB) that by 1986 FSLIC was already grievously damaged.

Straightforward and conservative opportunity-cost accounting of information collected in the S&L regulatory reporting system could have readily revealed the magnitude of FSLIC’s downward slide to higher elected officials. This is shown by
straightforward calculations made from these data summarized in Kane (1985, 1989) and more sophisticated analysis presented in Kane and Yu (1995). It is also shown by working papers prepared in the early and middle 1980s by FHLBB staff economists such as James Barth and H. Dan Brumbaugh. Their research sketched alarming patterns of cumulative decline in FSLIC’s net reserves and was meant to alert higherups to the severity of the problem facing them.

Using accounting flexibility to delay recognition of most of FSLIC’s opportunity-cost losses and loss exposures allowed official measurements of the fund’s net reserve position to cover up plainly relevant evidence of poor regulatory performance by the FHLBB and FSLIC.

Readers are invited to decide now whether they believe this de facto coverup was inadvertent or self-interested and to record their judgment on the first line of the Synthetic Grand Jury Ballot at the end of this essay.

Second Test. Did government officials seek to benefit personally or politically from misrepresenting FSLIC’s condition? Some officials have claimed they understated FSLIC’s problems only to achieve a greater good. They argue that releasing accurate official measurements of FSLIC’s condition would have panicked S&L depositors and provoked a deposit run that would have ruined the S&L industry and importantly disrupted the real economy.

This argument presupposes that few S&L depositors were aware that FSLIC was short of explicit economic reserves or understood that elected politicians faced strong political pressures to bail out FSLIC if and when a depositor run were to ensue. But, in the early 1980s, both of these propositions were strongly held by experts in banking and finance (Carron, 1982; Kane, 1985). In 1981, even the head of the FHLBB acknowledged in several public speeches that FSLIC was about $100 bil. underwater. Responding to Congressional concerns which were almost certainly influenced by pressure from S&L lobbyists, he continued to sign annual reports that proclaimed FSLIC to be solvent. Not long thereafter, he moved through the revolving door of public service
into a high-paying job in the mortgage-finance industry. Would that job have been available had he insisted that Congress resolve FSLIC’s insolvency?

Would incumbent members of Congressional Banking Committees have had a harder time running for re-election in 1982 if FSLIC’s weakness had been plainly stated and addressed? In March 1982, prior to running for re-election, these incumbents voted to pass Joint Congressional Resolution 290 which sought to assure depositors that the full faith and credit of the U.S. Treasury stood behind FSLIC and FDIC guarantees. Assuring worried depositors without explicitly funding FSLIC’s capital shortage supported lenient regulatory treatment for insolvent “zombie” S&Ls. This lenient treatment earned the gratitude of zombie managers by preventing the funding costs market participants imposed on their living-dead firms from rising fatally. Is it likely that elected and appointed officials truly did not care that acts of leniency and procrastination enhanced their professional reputations, re-election potential, and/or postgovernment career opportunities?

Readers are invited to contemplate these issues and to mark their conclusions on the second line of the synthetic ballot.

Third Test. Did continued misrepresentations of FSLIC’s condition ever prove material? Did putting misleading information into the FHLBB’s annual reports keep FSLIC’s losses from influencing campaign politics? Much as the lapse in watchfulness shown by the landowner in the parable, did taxpayer ignorance permit taxpayer harm to escalate?

Would taxpayers have forced a different pattern of regulation had the facts been clearer to them? Evidence that politicians thought so may be inferred from the absence of taxpayer losses from FSLIC as an issue in the 1984 and 1988 election campaigns. It is widely alleged that the bipartisan nature of contributions to the FSLIC mess led to backroom agreements between Democrat and Republican presidential candidates to remain silent about FSLIC’s shaky condition and accumulating losses.

Readers are invited to ponder these questions and to enter their judgment on the third line of the ballot.
Fourth Test. Did officials intend for taxpayers and voters to rely on these misrepresentations? When officials offer a pursuit-of-greater-good defense against the charge that they acted for personal benefit, they concede their intention to keep the bulk of society blissfully unaware of FSLIC’s weakness. It is hard to understand why Democrat challengers in 1984 and 1988 would have left FSLIC out of presidential campaign politics unless they feared that blowing the whistle on FSLIC mismanagement would adversely affect the Congressional wing of their party, the economy, and/or their own professional futures.

Just prior to FSLIC’s deaththroes, official underestimates of FSLIC’s reserve shortage in 1987 were used to downsize the amount of funds appropriated for resolving insolvent S&Ls. Debate over how much borrowing authority to create for FSLIC in the Competitive Equality Banking Act of 1987 turned on the extent of FSLIC’s immediate need for funds. It was alleged that establishing authority for FSLIC to borrow $10.8 billion would be enough to clean up industry insolvencies, even though calculations of the type summarized in Tables I and II could show that FSLIC needed an injection of ten times that amount.

It can also be documented that professional staff and academic economists were advising officials that leaving insolvent S&Ls in play distorted managerial incentives at these firms. This distortion disposed S&L managers toward looting (Akerlof and Romer, 1993) and go-for-broke behavior (Barth, 1991; Brumbaugh, 1993) that imposed expected losses on FSLIC and taxpayers.

Again, readers are encouraged to think through this issue and to mark their conclusion on line four of the ballot.

Fifth Test. Did taxpayers believe the false assurances? If taxpayers hadn’t believed, the press would not have had to apologize so hard in 1989 for having missed the unfolding story of FSLIC’s losses (Skidmore, 1992). Nor would influential members of the Banking Committees have been condemned so roundly by challengers when they ran for renomination and re-election in 1990, 1992, and 1994.
Did taxpayers in fact suffer harm? As detailed in the footnote to Table II, Congress has so far set aside $159 billion for use in resolving FSLIC’s insolvency. The cost to taxpayers would have been far lower had regulatory authorities routinely carved out a risk-balancing warrant position for taxpayers in every insolvent S&L they allowed to operate in an insolvent condition. Doing this would have rebalanced incentives for risk-taking at zombie institutions. Equally importantly, it would have allowed taxpayers to reap capital gains in return for the dividend-free implicit equity capital FSLIC provided to crippled thrifts that managed to regain their solvency. These gains would have been available to offset some of the $159 billion in losses taxpayers were accruing in the S&Ls that proved unable to sustain a recovery.

Readers are urged to decide these questions and to record their decision on the fifth line of the synthetic ballot.

**Lesser Charge of Negligent Misrepresentation.** Although a grand jury is entitled to guess at motivations and missing facts, some readers may be uncomfortable with inferring the required elements of regulatory intent. Any reader who could vote aye on the third and fifth charges can consider indicting officials on the lesser charge of negligent misrepresentation. Common-law fraud entails intentionally unethical behavior. Bear and Maldonado-Bear (1994) clarify that one can also be held accountable at law for “misrepresentation or concealment” that results from stupidity or negligence, without a deliberate intent to deceive, and thereby profit from, another. Although sometimes loosely characterized as a variety of fraud, the proper name for this behavior is negligent misrepresentation. For acts of negligent misrepresentation, a defendant is responsible at law if, in the course of his or her business or profession, the defendant supplies misinformation for the guidance of others in their business transactions that they rely on to their detriment. The defendant is responsible if she or he “fails to exercise that care and competence in obtaining and communicating the information which its recipient is justified in expecting.”

Most of the major S&L accounting firms have settled negligent-misrepresentation charges out of court. For having these charges dismissed without admitting guilt, five
members of the nation’s Big Six accounting firms have paid a total of $984 million. FDIC et al. (1994) clarifies that allegations of accounting malpractice include such negligent acts and procedures as:

- Improper workpaper and document retention practices, including violations of Generally Accepted Accounting Standards (GAAS) and regulation, that impacted on regulators’ ability to review accounting policies and practices of former clients and failed thrifts.
- Failure to mark trading accounts to market in accordance with Generally Accepted Accounting Practices (GAAP).
- Misapplication of GAAP requirements relating to accounting for acquisitions of savings and loan associations.
- Improper accounting for profits on sales of real estate and exchanges of assets.
- Failure to audit allowances for loan losses in accordance with GAAS.

Both at auditing firms and some Federal Home Loan Banks, evidence exists that underlings feared reprisals for blowing the whistle on efforts to overstate capital at crippled, but well-connected S&Ls. Readers must ask themselves whether it is plausible that competent and diligent S&L examiners and their regional and national supervisors would not have uncovered at least some of the particular weaknesses in reporting practices that embarrassed the accounting firms into paying compensation.

b. Influence-Peddling in Exchange for Private Benefits.

Our second charge alleges a conscious betrayal of the public interest in exchange for explicit or implicit compensation. Because such exchanges take place out of public view, it is hard to assemble convincing evidence without a back-up team of skilled investigators.

Such investigators did assemble persuasive cases of influence peddling against former House Speaker James Wright and former House Majority Whip Anthony Coehlo, both of whom resigned their seats in Congress as a result. Suggestive circumstances exist in many other cases, most notably for the Keating Five Senators and for the regulatory forbearances accorded the politically well-connected Silverado and Whitewater S&Ls.
Two points are clear. First, both at the state and federal level, S&L regulators routinely engaged in policies of leniency and indulgence in enforcing FSLIC and taxpayer interests in supervising insolvent S&Ls. Second, private benefits came to both politicians and top regulators from pursuing these policies. Lenient treatment of a zombie S&L almost always pleased one or more incumbent politicians holding office in the particular state in which the unresolved zombie was headquartered. It protected top regulators’ reputations against knee-jerk industry criticism of regulatory demands for recapitalization as merciless and unwise. It also spared their agencies the nuisance of having to defend themselves against stockholder and management lawsuits.

It is important to understand that, without federal deposit insurance, it would not have been possible for uncured shortages of equity capital at zombie S&L enterprises to persist. In the absence of federal guarantees, depositors and other creditors would have strong incentives to insist that a zombie enterprise raise more capital. If a voluntary recapitalization was not forthcoming, it would pay creditors to resolve the insolvency by taking over from pre-existing owners all or most of the ownership position in the firm. Takeover need not mean closure. If the S&L had solid going-concern values, creditors would accept warrants or other equity stakes in the operations of the S&L until either their claim was paid or they managed to find a willing buyer for the firm.

Shutting down an insolvent S&L that is truly needed by its community is seldom sensible. Any politician or regulator who claims that closure was the only viable alternative to leaving such a firm in business with dividend-free taxpayer support is speaking either from ignorance or with a forked tongue. Other corporate-finance options for extinguishing or diluting the claims of existing owners were available that could have served taxpayers better than closure. Offering poorly framed excuses for not having acted in timely fashion to resolve widespread S&L insolvencies serves to circulate disinformation. Readers are entitled to infer that resort to disinformation evidences an unwillingness to identify the true reasons for granting leniency.

It may be hard for readers to vote to indict politicians and regulators for influence peddling purely from observing suspicious patterns of activity and other forms of hard-to-
explain circumstantial evidence. But at a minimum, mulling the gaps in the evidence available ought to convince readers of the need to insist on improved campaign-finance laws and to impose stricter ethical and disclosure obligations on high-ranking public servants so that such gaps will be narrower in the future.

Activity that is consistent with influence peddling can be observed in the heavy flow of campaign contributions that was supplied to banking-committee members in both houses by political action committees (PACs) sponsored by S&L, construction, and real-estate trade associations and corporations (Kane, 1989, pp. 52-53). It is understood that campaign giving buys “access” to committee members for industry lobbyists. The importance of such access transforms Congressional committee assignments into licenses to milk the PACs of firms and industries whose business lies within each committee’s jurisdiction.

The buying and selling of access and influence is often described euphemistically as “participating in the political process.” But the undisguised ethical character of influence peddling can be clarified by contrasting some plain-spoken remarks with the carefully crafted defenses offered by defendants in influence-peddling scandals. The unguarded comments were captured by police on tape in Arizona during a sting operation, called AZSCAM. This operation videotaped negotiations in a candid-camera setting as a police agent sought to buy votes from individual members of the Arizona legislature to pass a bill that would legalize casino gambling in the state. The sentiments that a corruptible legislator was willing to express in bargaining for a better fee underscore the hypocrisy that customarily disguises the activities of buying and selling legislative votes in a representative democracy. These cynical views may be contrasted instructively with the defenses offered by the Keating Five senators. I suspect that the Senate Ethics Committee would have treated the Five far more harshly if any of their negotiations with Keating (either before or after pressuring FHLBB officials to go easy on Keating’s Lincoln S&L) had been taped.

In AZSCAM, legislators all but shouted the following comments into microphones:
1. “I want to die rich.” (Many elected officials do die rich, bravely overcoming low salaries and high expenses they face in public service).

2. “We all have our price.” (The purpose of this remark was to stress that someone who is uncomfortable with receiving payments in cash can still be open to a more subtly structured “deal.”)

3. “There isn’t an issue in the world I give a shit about. I do deals.” (This official went on to emphasize that his main interest in a deal was “what’s in it for me.”)

4. “This time I sold my vote too cheaply.” (When the previous official later discovered that another legislator had managed to sell his vote for $20,000 more than the candid deal-doer had received, he chalked it up as a learning experience.)

5. “I have done nothing improper.” (This is what all parties claimed when they were arrested.)

That they had done nothing improper was also the claim that emanated from every member of the Keating Five: Alan Cranston, Donald Riegle, John Glenn, Dennis DeConcini, and John McCain. These senators did not deny that they had exerted influence on FHLBB members to derail the efforts of the Federal Home Loan Bank of San Francisco to close Keating’s deeply insolvent $5.5 billion Lincoln Savings and Loan. Nor did they deny that each had received campaign funds and other benefits from Charles Keating and his associates. These points had been documented clearly (U.S. Senate, Select Committee on Ethics, 1991). Their defense was to deny that the pressure they exerted was connected to the substantial donations or other favors they had received from Mr. Keating.

Alan Cranston had a particularly hard time sustaining the plausibility of this claim. Not only had he solicited $850,000 from Keating interests for three organizations he founded or controlled, but the funds were received well after the April 1987 meeting at which the five senators energetically intervened with the FHLBB. The defense he
mounted on January 16, 1991 damns his colleagues, Congressional ethics, and the system for overseeing federal regulation: “Every senator has done it.”

A grand jury is free to disbelieve the senators’ claims that their intervention was unconnected to the favors they had received. It can do so on the grounds that these assertions defy common sense and are contradicted by Keating’s own conception of what he thought himself to be getting in return for the contributions he made. At a press conference held after his S&L was finally closed in April 1989, Keating was asked whether he believed that his generous support of politicians had helped him to handle regulators in the past. He replied: “I want to say in the most forceful way that I possibly can: I certainly hope so.” The chutzpah of this clever riposte made him an ideal target for subsequent federal prosecution. Nobody loves a wise-ass, particularly when the wit he exhibits intensifies pressure being felt by other members of the accountability-resistant Jackallian social network whose code of silence had protected him in the past.

c. Regulatory Gambling with Taxpayer Money.

I now invite readers to levy a third charge against the defendants: gambling at grossly unfair odds with taxpayer money. This accusation presumes the sort of guilty knowledge that is featured in our first charge. However, compared to the charge of influence peddling, the behavior alleged either assigns a less shameful motivation or stands as an additional and compounding breach of faith.

Kane (1989) emphasizes that incentives facing high government officials supported a two-part managerial strategy of: (1) covering up layered shortages of explicit capital at FSLIC and many insured S&Ls and (2) letting these shortages ride. The motivation for the letting-it-ride half of this analysis is summarized in a parable describing members of Congress who have stopped for dinner at an expensive Washington restaurant:

As political celebrities patronizing a D.C. restaurant, they soon find themselves seated at a prominent table. The prominence of their table tempts them to order the most expensive food and wine on the menu, on the gamble that a lobbyist at some other table will notice them and pick up
their check. They confidently expect the restaurant manager to fill even the most lavish orders. He does not worry about how much cash or what credit cards individual members of the dinner party may have brought with them. He is confident that one way or another someone will pay these customers’ bill in full. With the same confidence, the members of the dinner party end up staying at their table for an uncomfortably long time and even order an unwanted round or two of after-dinner drinks to give potential volunteers more time to grab their growing check (Kane, 1989, p. 3).

Year after year, rather than submitting the bill for S&L losses to taxpayers for immediate payment, officials hoped that if they waited a little longer insured institutions’ imbedded losses would be cured by extraordinarily lucky movements in bond, real estate, farm, and energy prices. Kane and Yu (1994) explain how FSLIC lost on average about $8 billion a year while officials sipped their after-dinner drinks, waiting for the luck of crippled S&Ls to change. The flaw in the policy of passive supervision lies in the failure to negotiate for taxpayers an enforceable and balanced claim on the upside profits that a crippled S&L might earn down the line. Such a claim was needed because deposit-insurance guarantees already assigned the downside of any zombie’s future earnings completely to FSLIC.

Making badly structured contributions of taxpayer capital to zombie thrifts would be indefensible in private corporate transactions. The problem of when and how to distribute losses in an insolvent firm is well-researched in corporate finance. As the capital stake put up by a firm’s stockholders declines, creditors have an incentive to step up to demand that stockholders recapitalize the firm or else. The “or else” involves greatly diluting or wiping out the stakes of existing stockholders and either bringing in new equity or assigning to creditors a properly balanced equity claim on the future upside of these firms.

Recapitalization by no means requires closure, but it does require that accrued losses be distributed across prior stakeholders in the firm. By not distributing past losses,
supervisory leniency distorted managerial incentives. It disposed zombie managers toward hell-for-leather funding and investment strategies that spread zombieness rather than controlled it (Kaufman, 1987).


The Commission’s story ignores the force of public-service incentives. It suggests that the oversight process was okay until FSLIC became insolvent. But the oversight process was perverted ab initio. For the most part, in the S&L mess private lobbyists responded to longstanding incentives in ways that Jackallian managerial and professional ethics openly bless. To clarify this point, it is necessary to investigate the role of the one player who became the biggest loser in the game: the federal taxpayer.

The Commission portrays taxpayers as completely innocent victims. This is mistaken in that official behavior inimical to taxpayer interests ought to have been foreseen and guarded against. The failure of government officials to man their “switches” adequately is not an aberration of the S&L mess. It is a general problem that our system of government must resolve. Even children sense that, in a game of repeated victimization, a compliant victim’s lack of resistance may be blameworthy in itself.

Conflicts in interest facing government servants in the FSLIC mess were aggravated by the conviction that taxpayers and the press were not concerned with monitoring them. Few outsiders can meaningfully assess the tradeoffs government officials make. Politicians and top regulators received immediate benefits from delivering leniency to constituents at zombie thrifts, but enjoyed a delayed and confused accounting for the costs and risk exposures this leniency passed through implicitly to taxpayers. Knowing that industry gratitude was assured while taxpayer criticism was uncertain tempted officials to gamble that they could bend to industry pressures and escape through the revolving door with their reputations intact.
When taxpayer burdens did finally surface, responsible officials shifted their activity into blame-shifting. Far from proposing policies that would resolve the conflicts of interest that persuaded some officials to feather their nests at taxpayer expense government spokespersons refused to acknowledge the relevance of incentive conflict. Instead, government officials framed the policy debate around incomplete theories of the mess. These partial theories fixed the blame for the mess wholly or largely outside of the government and distracted taxpayers from addressing the desperate need for genuine reforms in regulatory performance measurement, governmental ethics, and campaign funding.

The success of governmental efforts to furnish scapegoats for taxpayers to condemn supports the hypothesis that the taxpaying public deserves some of the victimization it gets. Taxpayers are inherently more interested in the gossipy task of pinning the blame for the policy debacle on a few sharp S&L operators and a few allegedly sleepy officials than it is in working to uncover and solve the incentive problems that underlie this or any other public-policy scandal. Public preference for gossip over intellectual analysis is underscored by the great attention paid to Michael Jackson’s alleged sexual deviancy, Woody Allen’s romance with his step-daughter, and Zsa Zsa Gabor’s run-in with an LA policeman. These personal-interest stories and the trial of O.J. Simpson each received more and better press than the $150 billion-plus deposit-insurance mess ever garnered. Twists and turns in the juiciest stories are followed closely by an attentive audience of tens of millions, while issues in deposit-institution regulation are followed closely by an audience numbered in the tens of thousands.

The National Commission (1993) charged with officially analyzing the FSLIC debacle framed its analysis around a distinction between factors that precipitated the damage and factors that merely intensified damage already done. The Commission’s Report uses this distinction to put the cart before the horse. It classifies “systematic breakdown in the political system” that “prevented corrective actions” (p. 7) as an
intensifying factor, while labelling the relaxation of regulatory and supervisory standards that was pulled by this incentive breakdown as a precipitating force.

The conceptual disengagement of mistaken supervisory policies from the incentives that led to their selection leaves the Commission’s work half-done. In an “Additional View” appended to the Commission report, Commission member Eliot H. Levitas makes much the same point. He states plainly that guardians of taxpayer interests in FSLIC (government officials and the press) “failed miserably in their jobs” and “deserve to be held accountable” (p. 86).

To establish accountability is precisely what we are asking readers to undertake here. What are now seen to be “miserable” governmental policies persisted over two decades. Is it reasonable to believe that these policies could have endured in the face of guilty knowledge about their damaging effects on taxpayers unless this pattern of loss shifting was systematically preferred to other alternatives by the succession of officials who were in charge of managing and overseeing FSLIC?

Readers are invited to decide for themselves whether this revealed preference constitutes a breach of faith with taxpayers.

III. No Easy Answers

The root issue in the S&L debacle has nothing to do with the nature of the S&L business. It doesn’t matter to taxpayers how individual S&Ls actually lost money. The questions that matter are why taxpayers suffered losses and why taxpayers could not see these losses when they were developing.

To frame an adequate program of public-service incentive reform, one needs a complete theory of taxpayer losses. Complete theories of the mess must focus on the behavior of government agents under conditions of asymmetric information.

Taxpayer losses resulted from their agents’ ability to take expedient actions to delay loss distribution and to hide both the true reasons and effects of these actions behind a smokescreen of disinformation. The coverup of specific actions and reasons continues to this day.
In this respect, the National Commission’s 1993 Report may be read as another brick in a wall which obstructs taxpayers’ view of who did what, when, and why? Authorities’ hiding of FSLIC losses is little different from efforts to cover up any unsavory actions officials take. Ironically, the Report treats governmental lying over the size of the budget deficit as routine, but offers policy recommendations that presume that truth-telling can easily be “required” of financial regulators.

The problem is to overcome authorities’ propensity to rescue troubled industries and to cover up the costs of making that rescue. Vague disclosure requirements cannot easily overcome accounting legerdemain to make rescue costs transparent. Authorities find it all too easy and all too useful to block the flow of unflattering information. Accountability for regulatory performance begins with assuring the timeliness and accuracy of information supplied by managers of insured institutions and ends with assuring that managers of deposit insurance funds make fully informative reports to politicians and the press.

One way to reduce the scope for covering up bad performance is to require that self-reporting of regulatory performance be based on opportunity-cost accounting principles of measurement that measure period-by-period changes in taxpayer loss exposure in insured institutions. This would entail at least three specific actions by Congress:

1. Defining what information supervisory authorities are to disclose in an operational manner free of obvious loopholes;
2. Specifying criminal and civil penalties for officials that sign off on willful inaccuracies and nondisclosures; and
3. Establishing a credible enforcement mechanism.

Such accounting and enforcement reforms seek to create incentives for regularly measuring and reporting the capitalized cost to taxpayers of caving in to pressure to allow troubled deposit institutions to operate insolvently. In the event of a future taxpayer bailout, such measurements would assist the press and voters to assign blame. Officials’
opportunities to claim ignorance of the long-term consequences of forbearance policies ought to prove more constrained than they were in the FSLIC mess.

One way to reduce the scope for influence peddling and regulatory gambling is to enact information-contingent action-forcing rules. These rules should spell out measurable performance standards and identify quality-assurance issues. Incentives ought to be established to define and penalize dereliction of duty at all levels of oversight. Duties to be mandated should include:

1. requiring deposit-insurance managers to recapitalize their insurance funds according to a relatively speedy timetable when and as they suffer opportunity-cost losses.
2. requiring losses that exceed deposit-insurance reserves to pass through the federal budget as they accrue.
3. requiring members of Congress and the Administration:
   • to set explicit and enforceable limits on their ability to intervene ethically into the process of closing individual institutions
   • to report all interventions on behalf of individual institutions to Congressional banking and ethics committees for explicit review
   • to subject committee reviews to regular evaluation by “disinterested” outside experts.

A complementary third way to improve incentives for deposit-institution regulators would be to privatize a first tier of accountholder deposit-insurance coverages. While government funds could continue to underwrite catastrophic risk, a privately insurable first layer of deposit-insurance coverage could be assigned to private bonding companies. These companies would have cleaner incentives to manage site examination and capital requirements for insured deposit institutions. The purpose would be to make government monitoring and supervision more transparent by pushing it back a step. Instead of examining thousands of deposit-institutions, officials would accept the simpler task of overseeing the condition and risk-management policies of a handful of private deposit insurers. Taxpayers’ ability to monitor regulators’ performance of this oversight
task would be assisted by observable market signals that competing insurers would receive from the financial and insurance markets in which they operate.

The difficulty of enacting any of this trio of reforms is a measure of the depth and stubbornness of the mess. Whether such reforms will ever seem desirable to elected officials will depend on the electorate’s willingness to face up to its monitoring responsibilities. One can only hope that voters penalize and shame incumbents for emergent government failures during future elections as strongly and as firmly as they did in 1994.
REFERENCES


## TABLE I

**COMPARISON OF OFFICIAL AND OPPORTUNITY-COST ESTIMATES OF FSLIC FINANCIAL HEALTH, 1975-1989**

<table>
<thead>
<tr>
<th>Year</th>
<th>Official Estimates of FSLIC Insurance Reserves (in $ billion)</th>
<th>Official Reserves as a Percent of Insured Deposits (in percent)</th>
<th>Assets at FSLIC-Insured Institutions (in $ billion)</th>
<th>Opportunity-Cost Value of FSLIC’s Net Accumulated Losses As a Percentage of Assets at Insured S&amp;Ls (in percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>4.1</td>
<td>1.5</td>
<td>329</td>
<td>-7.8</td>
</tr>
<tr>
<td>1980</td>
<td>6.5</td>
<td>1.3</td>
<td>615</td>
<td>-12.8</td>
</tr>
<tr>
<td>1985</td>
<td>4.6</td>
<td>0.5</td>
<td>949</td>
<td>-5.5&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>1986</td>
<td>-6.3</td>
<td>-0.7</td>
<td>1,164</td>
<td>-6.5&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>1987</td>
<td>-13.7</td>
<td>-1.5</td>
<td>1,251</td>
<td>-9.6&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>1988</td>
<td>a</td>
<td>a</td>
<td>1,350</td>
<td>-10.1&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>1989</td>
<td>a</td>
<td>a</td>
<td>1,301&lt;sup&gt;b&lt;/sup&gt;</td>
<td>-8.7&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
</tbody>
</table>


<sup>a</sup> The missing information was not released to the public until after FSLIC ceased to exist.

<sup>b</sup> September 30th figures calculated by Kane and Yu (1995, forthcoming).
## TABLE II
ECONOMIC CONDITION OF FSLIC AND RTC, 1985-1990

<table>
<thead>
<tr>
<th>Date</th>
<th>Opportunity Cost Value</th>
<th>Official Yearend Value</th>
<th>Economic Income</th>
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<tr>
<td>9/30/85</td>
<td>-$86 Bil</td>
<td>+ $4.6 Bil.</td>
<td>...</td>
</tr>
<tr>
<td>9/30/86</td>
<td>-$122 Bil</td>
<td>- $6.3 Bil.</td>
<td>-$45 Bil</td>
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<tr>
<td>9/30/87</td>
<td>-$107 Bil</td>
<td>- $13.7 Bil.</td>
<td>+$7 Bil</td>
</tr>
<tr>
<td>9/30/88</td>
<td>-$161 Bil</td>
<td>...</td>
<td>-$63 Bil</td>
</tr>
<tr>
<td>9/30/89</td>
<td>-$161 Bil</td>
<td>...</td>
<td>-$7 Bil</td>
</tr>
<tr>
<td>12/31/89</td>
<td>...</td>
<td>- $99.9 Bil.*</td>
<td>...</td>
</tr>
<tr>
<td>12/31/90</td>
<td>...</td>
<td>- $100.3 Bil.*</td>
<td>...</td>
</tr>
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</table>

* Accumulated Deficit reported by the Resolution Trust Corporation (RTC). RTC was asked to absorb FSLIC’s losses in all S&Ls for which a conservator or receiver was appointed between January 1, 1989 and August 8, 1992. RTC’s life and loss acceptance has been extended twice. Through December 31, 1993, RTC had received $123 billion in appropriations. Its latest legislated enddate is scheduled for July 1, 1995. The cynically named Savings Association Insurance Fund (SAIF) is standing by to take over future loss exposures in S&Ls when RTC closes shop.

Insurance losses on FSLIC’s books prior to 1989 did not go to the RTC. These losses were assigned to a separate FSLIC Resolution Fund that totalled $14.4 Bil. in Dec. 1989 and for which $22 Bil. more was appropriated in 1991.

Pulling appropriations to these two funds together, by December 31, 1993, $159 billion in taxpayer funds had been designated as filler for the hole in FSLIC’s negative net worth.
SYNTHETIC GRAND JURY BALLOT ON THE APPLICABILITY OF FIVE COMMON-LAW TESTS FOR FRAUD:

<table>
<thead>
<tr>
<th>VOTE</th>
<th>AYE</th>
<th>NAY</th>
</tr>
</thead>
<tbody>
<tr>
<td>• a conscious <strong>misrepresentation or concealment</strong> of the truth</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>• an <strong>intent to benefit</strong> by causing another party to rely on the untruth to his or her detriment</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>• the misrepresentation was <strong>material</strong> (i.e., directly related to the harm caused)</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>• there was an <strong>intent</strong> to cause the other party to <strong>rely</strong> on the misrepresentation to his or her detriment</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>• that the other party did <strong>believe, rely, and suffer</strong> provable harm.</td>
<td>☐</td>
<td>☐</td>
</tr>
</tbody>
</table>