

I N T R O D U C T I O N

The savings and loan crisis of the 1980s was one of the worst financial disasters of the twentieth century. The estimated cost to taxpayers, not counting the interest payments on government bonds sold to finance the industry's bailout, is \$150 to \$175 billion. If interest over the next thirty years is added to this tab, the cost approaches \$500 billion.¹

The savings and loan debacle involved a series of white-collar crimes unparalleled in American history. Numerous journalistic accounts and dozens of popular books, as well as authoritative pronouncements by economists and thrift industry consultants, have already appeared. One might wonder what more needs to be said. We believe a different approach is in order, as a number of myths have come to permeate popular understandings of the S&L scandal. Too often, for example, economists and financial experts have attributed the disaster to faulty business decisions or business risks gone awry. We argue instead that deliberate insider fraud was at the very center of the disaster. Furthermore, we contend that systematic political collusion—not just policy error—was a critical ingredient in this unprecedented series of frauds.

Following the tradition of research on white-collar crime by Edwin Sutherland and others, we examine not just the scope and scale

of the fraud but also the government's response to these corporate offenders. The popular press, with its unwavering eye for the sensational, has covered the prosecution, imprisonment, and recent release of high-profile suspect Charles Keating. The reality, however, is that the vast majority of savings and loan wrongdoers will never be prosecuted, much less sent to prison.

Finally, we argue that the kind of financial crime evident in the S&L crisis differs substantially from the typical corporate crime in the industrial sector. Such traditional corporate crimes as price-fixing or occupational safety and health violations are committed on *behalf* of the corporation and enhance profits, at the expense of workers and consumers. In contrast, the savings and loan crimes decimated the industry itself and brought the American financial system to the brink of disaster. This victimization of thrift institutions by their own management for personal gain, the existence of networks of co-conspirators with influential political connections, and other aspects of thrift fraud suggest a greater similarity to organized crime than to traditional corporate crime.²

With the current transformation of the global financial system, the nature of white-collar crime is changing too. The French economist and Nobel Prize-winner Maurice Allais has called the new finance capitalism a "casino" economy.³ Profits in this casino economy are made from speculative ventures designed to bring windfall profits from clever bets. In contrast to industrial capitalism, profits no longer depend on the production and sale of goods; instead, in finance capitalism, profits increasingly come from "fiddling with money."⁴ Corporate takeovers, currency trading, loan swaps, land speculation, futures trading—these are the "means of production" of finance capitalism.

The proliferation of finance capitalism has created new opportunities for white-collar crime, as the amount that can be reaped from financial fraud is limited only by one's imagination. But there is another way in which the new economic structure encourages

fraud, or at least fails to discourage it: unconstrained by long-term investments in the infrastructure of production (unlike their counterparts in manufacturing), perpetrators of financial fraud have little to lose by their reckless behavior. Their main concern is to make it big quickly, before the inevitable collapse. The repercussions of the rise of finance capitalism for both criminological theory and responsible policy making are substantial. We explore these repercussions and make modest—but no less urgent—recommendations for the prevention of future fraud-driven debacles.

THE SEARCH FOR RELIABLE DATA

In the late 1980s, as the savings and loan disaster was finally coming to public attention, members of Congress and the media urged more decisive action to bring the culprits to justice. Mounting evidence of massive frauds involving the loss of billions of dollars provoked an angry public to demand answers to tough questions: Who stole all the money? Why aren't they in prison? How much of the money can we get back? Government officials often pleaded ignorance, claiming they did not have adequate information to answer these questions.

This was not entirely an evasive tactic. While the federal government has spent billions of dollars developing sophisticated reporting systems to monitor street crime, there are virtually no comparable sets of data on far more costly suite crime. In the 1940s Edwin Sutherland explained that members of the lower class were overrepresented in official crime statistics because those statistics did not include economic crimes committed by high-status individuals in the course of doing business.⁵ Some fifty years later we still lack systematic information on the nature of white-collar crime, as well as official reporting and tracking procedures designed to capture its incidence or the government's response.

To construct a reliable and detailed picture of S&L fraud and its

prosecution, we were forced to start virtually from scratch. In addition to secondary sources such as government documents, regulators' reports, and other published accounts of the crisis, we gathered two sorts of primary data—interviews with key officials and statistical information on the government's prosecution effort. We interviewed 105 government officials involved in policy making, regulation, prosecution, and/or enforcement, both in Washington, D.C., and in field offices around the country, where investigation and prosecution take place. Our unstructured, open-ended conversations were a rich source of information about government procedure and practice. They also revealed a great deal about officials' perceptions of the crisis and the impact of these perceptions on decision making.⁶

Our statistical data proved indispensable for accurate estimates of the scale and scope of savings and loan crime and for deciphering the government's response. Although when we began this study there were no reliable data sources either to measure criminal activity in the industry or to track the many new criminal cases, this situation changed as public concern over the crisis and its price tag mounted. Pressures from many quarters, including Congress, forced federal agencies to develop computerized data systems to assess the dimensions of the problem and the government's response. We were able to gain access to this information, but only after extensive, and sometimes contentious, negotiations with officials at these agencies.

Some of the federal agency data sets were outdated, contained little information, or even failed to include important data, so that they were of no practical value. In the end we concentrated on data from three agencies: the Resolution Trust Corporation (RTC), the Office of Thrift Supervision (OTS), and the Executive Office of the U.S. Attorneys (EOUSA). These agencies had extensive computerized records on thrift fraud, but each focused on agency-specific interests—for example, regulators recorded criminal referrals, and

prosecutors kept track of indictments, convictions, and sentences. By carefully reconciling and integrating these disparate data sets, we can now provide a more comprehensive picture of the response to thrift fraud.

Of course, the picture is far from complete, and the data are inevitably imperfect. We can never be sure how much crime went undetected, and there is no way to be certain that the cases that did come to light were representative. While this is a concern in all criminological research, the problem is particularly acute for white-collar crime, where fraud is often disguised within ordinary business transactions and elaborate paper trails cover offenders' tracks.

Further, unlike such immediately recognizable common crimes as armed robbery, white-collar crimes of the sort that plagued the thrift industry are often apparent only after careful investigation and detective work.⁷ In a typical case of street crime, investigators start with a report that a crime has been committed, and the question they address is, Who did it? In contrast, white-collar crime investigators often start with a suspected con artist, and their question is, What did he or she do, and can we prove it? As one thrift investigator told us, "We pretty much know who the players are here, but we don't know exactly what they did."⁸ Given the difficulties of detecting and prosecuting this kind of white-collar crime, much of it probably goes unrecorded.

Those of us who study white-collar crime are usually stuck with examining only cases that have found their way into the official process of arrest and prosecution. We have no information about offenders who "get away" undetected or who are not prosecuted even though there is some evidence of wrongdoing. One way to attack this problem is to use "criminal referrals"—that is, official reports of suspected misconduct—as a rough indicator of fraud. Although this is by no means a definitive measure of crime, it is the best available. Together with indictment and prosecution information, criminal referrals can provide us with some idea of how this

front end compares to the indictment stage through which only a minority of offenders flow.

The filing of a criminal referral is the first official step in the process by which suspected thrift fraud is investigated and in some cases prosecuted. These referrals, usually filed by examiners from a regulatory agency or by individuals at the institution itself, describe the suspected crimes and the individuals who may have committed them; they also estimate the dollar loss to the institution. Referrals are generally sent to the regulatory agency's field office, where they are forwarded to the regional office and ultimately to the Federal Bureau of Investigation (FBI) and the U.S. Attorney's Office for investigation. In relatively few cases, this investigation results in an indictment by the U.S. Attorney, and the case proceeds to federal court.

In addition, a substantial number of indictments are initiated against persons never named in a criminal referral. For example, during an investigation the FBI or a U.S. Attorney may uncover evidence of crimes not mentioned in the referral and seek an indictment based on that evidence. In Texas, we discovered, more than a third of the individuals indicted in major S&L cases had not been cited in criminal referrals. Criminal referrals thus probably significantly underestimate the "crime rate" within the thrift industry.

In this regard, the data on criminal referrals at S&Ls are similar to official statistics on crimes known to the police. The accuracy of these official figures as measures of common crime, or street crime, is limited by the existence of a so-called dark figure of crime—that is, the significant number of crimes never reported to the police. Despite this problem, policy makers and social scientists routinely rely on the number of crimes known to the police to gain some sense of the incidence and distribution of common crime in the United States. Similarly, we use the criminal referral as an indicator of thrift crime with the understanding that referrals do not cover all instances of fraud.

It is true, of course, that criminal referrals are not held to the same evidentiary standards as convictions, and in some cases referrals may have been filed when there was no real criminal misconduct. Nonetheless, from our conversations with regulators and investigators and from our perusal of detailed criminal referrals, it is clear that these forms were not filed frivolously. Indeed, because of the amount of information required and because the credibility and reputation of the filing agency are at stake, only the most egregious cases of suspected misconduct are likely to be referred.⁹

So the primary problem with using referrals as an indicator is that they almost certainly underestimate thrift fraud.¹⁰ Since one of our principal findings is that thrift crime was pervasive, but only a few of its perpetrators will ever be prosecuted, this bias works to understate our case. If there were a more inclusive indicator of thrift fraud, we would find that the percentage of those who are actually prosecuted and sentenced to prison is even lower.

The politics of our research and the implications for data quality are worth mentioning here. One reason we found it so difficult to obtain reliable data for this study was the highly politicized environment in which the S&L crisis unfolded. Many of the details of the S&L scandal were kept from the public until after the presidential election of 1988. Once the enormity of the problem became clear, politicians from both parties were eager to minimize the estimated costs of the thrift crisis as well as their own responsibility for creating the conditions that allowed the crisis to escalate. From the perspective of many of these politicians, the less the public knew, the better. Thus the obstacles we faced were unusually formidable.

One clear-cut example of these obstacles involved a senior federal official who almost succeeded in derailing our project. From the outset our negotiations with his office over access to key data on thrift fraud were unnecessarily contentious. Even though the data we requested were readily available in computerized form and

could be easily downloaded onto floppy disks, this official refused to provide the disks. Instead, his staff gave us hard copy printouts for individual cases. We were then forced to laboriously re-create the original computerized format. At first we believed that the official's reluctance to give us the disks stemmed from simple ignorance; indeed, he and his staff seemed to believe that there might be some confidential information "hidden" somewhere on the disks. But the basis for his reluctance was not so simple, as later events revealed.

In an informal meeting we shared some of our preliminary findings (what we thought was noncontroversial descriptive information) with this official's staff. Soon after, we sat down with an advisory board, consisting of members of several federal agencies, to discuss the access we needed for our project. Before the meeting had even started, the senior official burst into the room. He proclaimed that he had ordered us not to pursue certain lines of inquiry with the data from his office and that we had disobeyed. We were "bean counters," he accused, and we were wasting taxpayers' money by duplicating work being done by his office. He then demanded that we not present our statistical data to the advisory board and abruptly left the room. Considerably taken aback by this unexpected turn of events, we were forced to adjourn the meeting.

We soon learned that this official had contacted our funding agency to insist that we stop analyzing the data that had led us to the "forbidden" lines of inquiry. He further stipulated that all future data analysis be submitted to his office "before they are made public or disseminated in any way." We recognize that government agencies may need to withhold confidential information if it jeopardizes ongoing civil and criminal investigations and prosecutions. Yet the data we requested simply involved information that had ostensibly been collected to keep Congress and the public abreast of the S&L cleanup. The problem was eventually resolved through delicate negotiations, but our project was put on hold for several months while this was sorted out.

More prosaically, although the federal government devoted hundreds of millions of dollars to the investigation and prosecution of S&L cases, few funds were earmarked for the routine collection of data on how those efforts were proceeding. In some cases individual prosecutors were forced to create their own small data bases, using whatever resources and expertise they could muster. Our ability to gain access to those decentralized files was critical to our project. But, once the files were obtained, we still faced the tedious and time-consuming tasks of cleaning, cross-checking, and reformatting the data. Official data on white-collar crime seems just as elusive as in Sutherland's day.

A SHORT HISTORY OF S&LS

To understand the S&L crisis, it is important first to know some history. The federally insured savings and loan system was established in the early 1930s to promote the construction of new homes during the Depression and to protect financial institutions against the kind of devastation that followed the panic of 1929. The Federal Home Loan Bank Act of 1932 established the Federal Home Loan Bank Board (FHLBB), whose purpose was to create a reserve credit system to ensure the availability of mortgage money for home financing and to oversee federally chartered savings and loans. The second principal building block of the modern savings and loan industry was put in place when the National Housing Act of 1934 created the Federal Savings and Loan Insurance Corporation (FSLIC) to insure S&L deposits.¹¹

Until 1989 the FHLBB was the primary regulatory agency responsible for federally chartered savings and loans. This independent executive agency was made up of a chair and two members appointed by the president. It oversaw twelve regional Federal Home Loan Banks, which in turn served as the conduit to individual savings and loan institutions. The district banks provided a pool of funds—for disbursing loans and covering withdrawals—to their

member institutions at below-market rates. In 1985 the FHLBB delegated to the district banks the task of examining and supervising the savings and loans within their regional jurisdictions.

The FSLIC, also under the jurisdiction of the FHLBB, provided federal insurance on savings and loan deposits. In exchange for this protection thrifts were regulated geographically and in terms of the kinds of loans they could make. Essentially, they were confined to issuing home loans within fifty miles of the home office. The 1960s brought a gradual loosening of these restraints—for example, the geographic area in which savings and loans could do business was extended and their lending powers were slowly expanded—but this did not significantly alter the protection/regulation formula.

A number of economic factors in the 1970s radically changed the fortunes of the savings and loan industry and ultimately its parameters. Thrifts had issued hundreds of billions of dollars of thirty-year fixed-rate loans (often at 6 percent), but they were prohibited from offering adjustable rate mortgages (ARMs). Thrift profitability thus declined rapidly as interest rates climbed. By the mid-1970s the industry was insolvent on a market-value basis (i.e., based on the current market value of its assets rather than on their reported book value). With inflation at 13.3 percent by 1979 and with thrifts constrained by regulation to pay no more than 5.5 percent interest on new deposits, the industry could not attract new money. When Paul Volcker, head of the Federal Reserve Board, tightened the money supply in 1979 in an effort to bring down inflation, interest rates soared to their highest level in the century and triggered a recession. Faced with defaults and foreclosures as a result of the recession and with increased competition from high-yield investments, given the hikes in the interest rate, S&Ls hemorrhaged losses. By 1982 the industry was insolvent by \$150 billion on a market-value basis and the FSLIC had only \$6 billion in reserves.¹²

Coinciding with these economic forces, a new ideological move-

ment was gathering momentum. Since the early 1970s, policy makers had been discussing lifting the restrictions on savings and loans so that they could compete more equitably for new money and invest in more lucrative ventures. But it was not until the deregulatory fervor of the early Reagan administration that this strategy gained political acceptance as a solution to the rapidly escalating thrift crisis. Throwing caution to the wind and armed with the brashness born of overconfidence, policy makers undid most of the regulatory infrastructure that had kept the thrift industry together for half a century.

They believed that the free enterprise system works best if left alone, unhampered by perhaps well-meaning but ultimately counterproductive government regulations. The bind constraining the savings and loan industry seemed to confirm the theory that government regulations imposed an unfair handicap in the competitive process. The answer, policy makers insisted, was to turn the industry over to the self-regulating mechanisms of the free market. In 1980 the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) began to do just that by phasing out restrictions on interest rates paid by savings and loans.¹³ This move to the free market model, however, was accompanied by a decisive move in the *opposite* direction. At the same time that the law unleashed savings and loans to compete for new money, it bolstered the federal protection accorded these “free enterprise” institutions, increasing FSLIC insurance from a maximum of \$40,000 to \$100,000 per deposit. As we will see in chapter 3, this selective application of the principles of free enterprise—spearheaded in large part by members of Congress with ties to the thrift industry—laid the foundation for risk-free fraud.

When the industry did not rebound, Congress prescribed more deregulation. In 1982 the Garn–St. Germain Depository Institutions Act accelerated the phaseout of interest rate ceilings.¹⁴ Probably more important, it dramatically expanded thrift investment powers,

moving savings and loans farther and farther away from their traditional role as providers of home mortgages. They were now authorized to increase their consumer loans, up to a total of 30 percent of their assets; make commercial, corporate, or business loans; and invest in nonresidential real estate worth up to 40 percent of their total assets. The act also allowed thrifts to provide 100 percent financing, requiring no down payment from the borrower, apparently to attract new business to the desperate industry. On signing the fateful bill, President Reagan said, "I think we've hit a home run." The president later told an audience of savings and loan executives that the law was the "Emancipation Proclamation for America's savings institutions."¹⁵

The executive branch joined in the "emancipation." In 1980 the FHLBB removed the 5 percent limit on brokered deposits, allowing thrifts access to unprecedented amounts of cash. These deposits were placed by brokers who aggregated individual investments, which were then deposited as "jumbo" certificates of deposit (CDs). Since the maximum insured deposit was \$100,000, brokered deposits were packaged as \$100,000 CDs, on which the investors could command high interest rates. So attractive was this system to all concerned—to brokers who made hefty commissions, to investors who received high interest for their money, and to thrift operators who now had almost unlimited access to funds—that brokered deposits in S&Ls increased 400 percent between 1982 and 1984.¹⁶

In 1982 the FHLBB dropped the requirements that thrifts have at least four hundred stockholders and that no one stockholder could own more than 25 percent of the stock, opening the door for a single entrepreneur to own and operate a federally insured savings and loan. Furthermore, single investors could now start up thrifts using noncash assets such as land or real estate. Apparently hoping that innovative entrepreneurs would turn the industry around, zealous deregulators seemed unaware of the disastrous potential

of virtually unlimited new charters in the vulnerable industry. Referring to this deregulatory mentality and the enthusiasm with which deregulation was pursued, a senior thrift regulator told us, "I always describe it as a freight train. I mean it was just the direction and everybody got on board."

The deregulatory process was accelerated by the fact that federal and state systems of regulation coexisted and often overlapped. State-chartered thrifts were regulated by state agencies but could be insured by the FSLIC if they paid the insurance premiums, which most did. By 1986 the FSLIC insured 92.6 percent of the country's savings and loans—holding over 98 percent of the industry's assets.¹⁷ The dual structure, which had operated smoothly for almost fifty years, had devastating consequences within the context of federal deregulation. As the federal system deregulated, state agencies were compelled to do the same, or risk their funding. The experience of the California Department of Savings and Loans (CDSL) is a good example of this domino effect of deregulation.

Beginning in 1975 the CDSL was staffed by tough regulators who imposed strict rules and tolerated little deviation. California thrift owners complained bitterly, and when federal regulations were relaxed in 1980, they switched en masse to federal charters.¹⁸ With the exodus, the CDSL lost more than half of its funding and staff. In July 1978 the agency had 172 full-time examiners; by 1983 there were just fifty-five.¹⁹

The California Department of Savings and Loans learned the hard way that if it was to survive (and if state politicians were to continue to have access to the industry's lobbying dollars), it had to loosen up. On January 1, 1983, the Nolan Bill passed with only one dissenting vote, making it possible for almost anyone to charter a savings and loan in California and virtually eliminating any limitations on investment powers.²⁰ As a savings and loan commissioner for California later said of the deregulation, "All discipline for the savings and loan industry was pretty well removed." Spurred on by

consultants and lawyers who held seminars for developers on how to buy their own “moneymaking machines,” applications for thrift charters in California poured in.²¹ By the end of 1984 the CDSL had received 235 applications for new charters, most of which were quickly approved.

Some states, such as Texas, already had thrift guidelines that were even more lax than the new federal regulations, but those that did not quickly enacted “me-too” legislation.²² By 1984 thrift deregulation was complete, except, of course, that the industry was now more protected (by federal insurance) than ever before. *Business Week* pointed out the discrepancy: “In a system where the government both encourages risk taking and provides unconditional shelter from the adverse consequences, excess and hypocrisy can be expected to flourish in equal measure.”²³

Deregulation was heralded by its advocates as a free market solution to the competitive handicap placed on thrifts by restraints on their investment powers and interest rates. But the cure turned out to be worse than the disease. Deregulating interest rates triggered an escalating competition for deposits, as brokered deposits sought ever higher returns. One commentator attacked the logic of the deregulation frenzy: “[It can] be summed up by saying that, beginning in 1980, the thrift industry was turned loose to its own devices to find its own way out of its difficulties by taking in more high-priced deposits and lending them out at better than the historically high rates then prevailing. As an article of financial wisdom, this ranks with the notion, held by some, that it is possible to borrow one’s way out of debt.”²⁴

It was worse than that. Deregulation not only sunk thrifts deeper into debt as they competed for “hot” brokered deposits, but more important, it opened the system up to pervasive and systemic fraud. With federally insured deposits flowing in, virtually all restrictions on thrift investment powers removed, and new owners flocking to the industry, deregulators had combined in one package the

opportunity for lucrative fraud and the irresistible force of temptation. L. William Seidman, former chair of the Resolution Trust Corporation, which was responsible for managing the assets of failed thrifts during the bailout, blamed the S&L crisis on the combination of deregulation and increased deposit insurance (which he called “a credit card from the U.S. taxpayers”). He underlined the possibilities for fraud that this combination opened up: “Crooks and highflyers had found the perfect vehicle for self-enrichment. Own your own money machine and use the product to make some highodd bets. We provided them with such perverse incentives that if I were asked to defend the S&L gang in court, I’d use the defense of entrapment.”²⁵

Business Week struck a warning note as early as 1985 with its tongue-in-cheek description of the “Go-Go Thrift”: “Start an S&L. Offer a premium interest rate and watch the deposits roll in. Your depositors are insured by Uncle Sam, so they don’t care what you do with their money. And in states like California, you can do almost anything you want with it. Add enormous leverage—you can pile \$100 of assets on every \$3 of capital—and you’ve built a speculator’s dream machine.”²⁶

Losses piled up. In 1982 the FSLIC spent more than \$2.4 billion to close or merge insolvent savings and loans, and by 1986 the agency itself was insolvent.²⁷ As the number of insolvent thrifts climbed, the FSLIC was forced to slow the pace of closures. The worse the industry got, the more likely its institutions would stay open, as the FSLIC was now incapable of closing their doors and paying off depositors. As the zombie thrifts churned out losses, the price tag for the inevitable bailout mounted.

As we write this, Charles Keating has been released from prison, his federal conviction thrown out on the grounds of jury misconduct. Although this judicial decision says nothing of the merits of the case against Keating, it inevitably provokes speculation that the role of criminal misconduct in the savings and loan crisis may have been exaggerated by prosecutors and a scandal-hungry media:

If even this poster boy of the S&L crisis cannot be successfully prosecuted, perhaps thrift crime was not so rampant after all. In the face of such speculation, it becomes even more critical to reexamine the record of the thrift debacle and the role of fraud in the industry's collapse. It is critical not only for our understanding of the dynamics of this sort of white-collar crime, but to put in place policies that will prevent such financial disasters in the future.