“All in All, I Think We Hit the Jackpot”: Garn-St. Germain and the Reagan Administration’s Faith in Deregulation

As he signed the new deregulatory law on 15 October 1982, Ronald Reagan declared that the Garn-St. Germain Depository Institutions Act (1982) “is the most important legislation for financial institutions in the last 50 years… [It] represents the first step in our administration’s comprehensive program of financial deregulation…[It] will make the thrift industry a stronger, more effective force in financing housing for millions of Americans in the years to come.”

Garn-St. Germain, which passed both Houses of Congress by overwhelming margins, expanded the investment powers of thrifts, counteracting the burgeoning instability in savings and loan institutions. The new law, asserted one administration official, provided the “elbow room” necessary for savings and loan institutions to weather the high inflation and high interest rate storms of 1981 and 1982, which by August 1982 had cost thrifts some $8.5 billion.

The savings and loan industry long provided Americans with affordable housing, especially after World War II. Americans utilized savings and loans as depository institutions, which in turn financed long-term mortgages and a small number of consumer loans. Most mortgages given by savings and loan associations were fixed-rate mortgages, which during the 1950s and 1960s fluctuated between five and six percent. The high inflation during the 1970s,

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1 The term thrift and savings and loan association/institution will be used interchangeably throughout this essay.
however, created a problem for savings and loan associations because the interest they were receiving from fixed-rate mortgages was not sufficient to cover their operating expenses and simultaneously offer new mortgages while also maintaining the federally mandated reserve minimums. Banks began to offer new types of checking and savings accounts and lower minimums on certificate of deposits in response to chronic inflation. Meanwhile, competition from high-interest yielding money market accounts offered by “non-banks” made it increasingly difficult for savings and loan associations to attract deposits.

Washington insiders were befuddled by this new world of stagflation. Many on the left and right contended that government regulation of private industry—including the financial sector—had contributed to the stagflation of the 1970s, in addition to hampering competition, innovation, and investment. Consequently, many legislators and academics, Democrats as well as Republicans, favored a general deregulation of U.S. business, trade, and financial institutions. Senator Edward Kennedy (D-Massachusetts), for example took the lead in the deregulation of American airlines, railroads, and trucking industries. Kennedy, in addition to President Carter, wanted to change the Democrats’ perception as the party that supported “big bureaucracy, cozy relations with labor unions, and interventionist economic regulations.”

Economist Alfred Kahn of Cornell argued that the government should deregulate particular industries because regulations limited competition and created higher costs for consumers and corporations. For many then, the economic realities of the 1970s encouraged support for deregulatory efforts.

Ronald Reagan, during the 1980 presidential campaign, explicitly blamed the legacies of the New Deal and Jimmy Carter’s liberal policies for creating and perpetuating a pessimistic national mood and an economic recession; contradictions Reagan hoped to redress by winning

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the presidency. According to James Farr, scholar of the relations of politics and ideas, change typically occurs when individuals attempt “to solve speculative or practical problems” by offering new solutions “to resolve contradictions which their criticism has exposed in their [opponents] beliefs, actions, and practices.” Therefore, without identifying a problem, establishing its cause, and offering viable alternatives, change is not likely to occur. Reagan’s conservative ideology, which lauded economic deregulation and smaller government, promised change that would unfetter the American economy from the liberal vestiges that were sucking the capital lifeblood from its free market veins.

Reagan’s conservative ideology reflected an unapologetic faith in the free market. His administration successfully created a “corporate welfare state,” which transferred resources from social welfare programs to taxpayer-funded subsidies for corporate risk taking and industrial bailouts, with the savings and loan bailout serving as one glaring example. This change, brought about by the deregulatory policies of the Reagan administration, exemplified how Ronald Reagan successfully changed regulatory practices and initiated a concerted conservative presidential and legislative assault on the New Deal state. The savings and loan crisis—in particular—provided the Reagan administration and conservatives the opportunity to diminish the regulatory efficacy of the Emergency Banking Act of 1933 (Glass-Steagall), the McFadden Act of 1927 (prohibited interstate banking), and the Douglas Amendment to the Bank Holding Company Act of 1956 (disallowed interstate bank acquisitions), which represented “old” legislation that favored local banks and state regulatory control. Given the economic instability of the 1970s, however, Glass-Steagall, McFadden, and Douglas were increasingly interpreted by

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politicians and economists alike as perpetuating market inefficiencies and burdensome regulations.

An examination of the savings and loan crisis reveals the extent to which the Reagan administration’s ideological predilections manifested themselves in the debate over the appropriate degree of economic deregulation needed to revitalize and restructure an industry that—since the Great Depression—had filled a market niche created and sustained by the federal government. Through government-mandated interest rate differentials that gave thrifts an advantage over commercial banks and through generous tax abatements, savings and loan associations provided millions of Americans the opportunity to achieve a component of the “American dream” by owning their own home. The aforementioned high inflation and high interest rates of the late 1970s and early 1980s threatened the market niche that thrifts filled. These economic circumstances that jeopardized thrifts specifically, and the U.S. financial industry more broadly, forced politicians and academics to consider the degree of government culpability for the current economic crisis, and to debate the appropriate government response(s) to this looming economic disaster.

This study aims to accomplish several related goals. It demonstrates how the Reagan administration faithfully adhered to a conservative rhetoric—replete with references to the free market, competition, and fiscal responsibility—to justify deregulating both the assets and liabilities of thrifts and banks. It highlights the arguments presented by financial industry executives to protect their business interests in light of the potential regulatory and structural changes needed to re-stabilize the financial system. It demonstrates the negative impact of deregulation and reorganization strategies on the financial sector in the United States. It emphasizes the unique role that thrifts and other depository institutions played in the American
economy, especially in terms of capital formation, community building, and consumer faith in the system. It also reveals the highly contentious nature of the political and corporate debates over the changes necessary to alleviate the pressures that were threatening to destabilize the entire American financial system, which included the dual banking system, deposit insurance, and expanding holding companies.

The Garn-St. Germain Depository Institutions Act of 1982 provided capital (via net worth certificates) for ailing thrifts, eased restrictions for merging thrifts and ownership requirements, and increased thrift investment opportunities by allowing them to invest up to 40 percent of assets in commercial mortgages, 11 percent of assets in secured or unsecured commercial loans, and 3 percent of assets as direct equity investments in business. Senator Jake Garn (R-Utah) and Congressman Fernand St. Germain (D-Rhode Island), in cooperation with Reagan administration officials and the U.S. League of Savings Associations, crafted a bill that Reagan believed “hit the jackpot.” Given the extent to which scholars have blamed the “casino economy”—enabled by Garn-St. Germain—for the eventual collapse of the savings and loan industry, Reagan’s gambling metaphor proved more accurate than he originally intended.

Analysis of Congressional testimony and Reagan administration memoranda concerning Garn-St. Germain, among other deregulatory efforts, reflects the self-interested policies of savings and loan associations, while also illustrating how bank executives firmly advocated for an atmosphere of free “competition” and customer convenience. Both concepts were euphemisms for providing banks with the opportunity to expand services and seize larger

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8 Mason, Bail-Outs, 219. The “direct equity investments” also allowed for investment in junk bonds, which were high-risk financial instruments that proved scandalous as well.
portions of the financial services market. These efforts failed to address the fundamental problems that thrifts faced and ultimately hastened the collapse of the industry.

Historical Development of Thrifts and Banking Regulation

After the stock market crash of 1929, politicians quickly mobilized to ban banks from servings as both depository institutions and investment brokers. Since banks essentially gambled away millions of dollars in savings from depositors, Congress enacted Glass-Steagall, which separated commercial and investment banking and created the Federal Depository Insurance Corporation (FDIC). It sought to prevent the possibility of providing one set of financial institutions with the opportunity to once again have a vested stake in particular corporate stocks while simultaneously potentially lending funds to that corporation, its workers, and its share holders.

The Federal Home Loan Bank Act of 1932 was also passed during the Great Depression. It served three primary objectives: to provide secondary liquidity to mortgage lending institutions with cash flow problems, to transfer funds from savings surplus to savings deficit areas, and to stabilize the residential construction and financing industries.\(^\text{11}\) The act also created the Federal Home Loan Bank Board (FHLBB), the agency charged with regulating savings and loan associations. In 1934, the National Housing Act legislated into existence the Federal Savings and Loan Insurance Corporation (FSLIC), the savings and loan counterpart to the FDIC. It served, initially, to provide “safety for the small saver” and “an element of integrity to the

entire system of thrift institutions.” Savings and loan institutions established connections with their local communities and individual patrons, an intangible benefit that is difficult to assign a monetary value and politically expedient to underemphasize, which became evident during the deregulatory debates of the 1970s and 1980s.

When interest rates began climbing in the mid-1960s, Congress passed the Interest Rate Adjustment Act of 1966. The act authorized the FHLBB to establish interest rate ceilings for thrifts, in conjunction with corresponding rates for banks. The rate for banks, however, was .25 percent lower than thrifts. What became known as Regulation Q demonstrated the federal government’s willingness to actively protect and encourage savings and loan institutions prosperity, quite openly, at the expense of other financial industries such as commercial banks. Moreover, throughout the 1970s, Congress passed numerous pieces of legislation, such as the Housing and Community Development Act (1974), Home Mortgage Disclosure Act (1975), the Housing Authorization Act (1976), and the Revenue Act (1978), that benefitted homeowners or eased restrictions for savings and loan institutions to lend credit more easily. By 1979, 4,709 savings and loan institutions existed, with assets exceeding $580 billion.

Deregulation Before Ronald Reagan

The U.S. economy began to stagnate in the early 1970s, a result of the oil embargo of 1973 and the subsequent energy crisis, increased levels of international competition, decreased manufacturing output, and Nixon’s termination of U.S. participation in the Bretton Woods Agreement. Moreover, economists and politicians were baffled by the combination of rising unemployment and inflation—known as stagflation—because, from a Keynesian perspective, the

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12 Woerheide, *Savings and Loan industry*, 5.
two had an inverse relationship. As government officials and academics tried to explain these anomalous conditions, a potential for conceptual change along the lines that political theorist James Farr posited increased. Many on the left and right became more vocal with their criticism that the federal government was to blame for these economic conditions, especially federal regulations on private industry.

Regulation Q—a prime example of government “intrusion” into the market—became a point of contention during the 1970s as a result of the yearly rise in inflation, which by 1980 was 13.5 percent. Savers were losing money by depositing money into accounts that had interest-rate ceilings. Savings and loan associations were conflicted over the possible removal of Regulation Q. Some believed Q was necessary for their survival, whereas others maintained that Congress must allow thrifts to diversify their investment portfolios to combat the ill-effects of a high-inflation, high-interest rate economy. Another economist who supported deregulation, Edward Kane, then the Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University, outright condemned the existence of Regulation Q. He argued, “It is widely recognized that government regulation impedes progress and limits customer satisfaction.” He also warned that the “S&L political alliance with housing could easily backfire against them.”

Congress, in its attempts to address the economic problems that emerged during the Nixon and Ford administrations, laid the foundation for many of the changes instituted during the Carter years. The Carter administration oversaw deregulation in trucking and airline industries and in energy production. In March 1978, Carter issued Executive Order 12044, which, according to Carter, promised

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15 Ibid, 61.
16 Gerston, Deregulated Society, 45.
to make the federal regulations clearer, less burdensome…and will ensure that federal regulations are cost-effective and impose minimum economic burdens on the private sector…the agencies are to eliminate those [regulations] which are unnecessary and reform others to reduce the burden to the minimum.17

Carter’s rhetoric closely mirrored the language used by conservatives like Reagan to justify deregulatory efforts, especially in the financial and industrial sectors where Carter believed government regulations were triggering higher inflation rates. His deregulatory policies, however, exhibited a hesitancy—exacerbated by his lingering support for Keynesian economics—that distinguished Carter from conservatives, in addition to his inconsistent attitude towards government oversight. He personally desired a robust social regulatory framework that protected the environment, evidenced by the passage of the Resource Conservation and Recovery Act (1976), the Toxic Substances Control Act (1976), the Surface Mining Control and Reclamation Act (1977), and major revisions to the Clear Air Act (1978).18

In August 1979, Federal Reserve Board Chairman Paul Volcker—nominated by Jimmy Carter to curb rising inflation—announced that monetary policy would no longer aim to keep interest rates low. The benchmark federal funds rate, over the next eight months, rose from 10.47 percent to 17.61 percent, and by January 1981, it had soared to 19.08 percent. Volcker’s policies crippled an already struggling industry, and dramatically increased the need for legislative intervention. Thrifts had lost billions of depository funds as individuals moved their money from low-interest rate passbook accounts to money-market mutual funds that paid market-rates. Between 1978 and 1982, the unregulated investments of money-market mutual funds exploded from $9.5 billion to $236 billion. Additionally, the interest from low-rate mortgages no longer produced sufficient funds to attract new investment. With Regulation Q still in effect, this turn of

17 Quoted in Gerston, *Deregulated Society*, 46.
18 Gerston, *Deregulated Society*, 45.
events effectively created a situation such that thrift liabilities would outnumber their assets, which quickly turned slim profits into growing losses for many thrifts. Industry profits fell from $3.6 billion in 1979 to only $781 million in 1980, and more important, almost half of all savings and loan institutions were “technically insolvent” because their total capital had fallen below the required minimum of 5 percent of insured deposits.\textsuperscript{19} By the end of 1980, 141 associations (with assets of $9.8 billion) were merged out of existence.\textsuperscript{20} In response to these dire conditions, in response to an April 1979 U.S. Circuit Court ruling that declared banks were discriminating against small savers, an overwhelming Democratic Congress passed, and President Carter signed, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA).

DIDMCA represented President Carter’s cautious attempt to deregulate thrifts; it proved ineffectual, however, because Carter feared a potential political backlash from consumer groups and business executives. DIDMCA created the Depository Insurance Deregulation Committee (DIDC) to carry out a six-year phase out of deposit rate ceilings. The DIDC had five members, the Federal Reserve Board Chairman, Treasury Secretary, Chairmen of the FHLBB and FDIC, and the National Credit Union Administrator. The legislation also authorized NOW accounts for individuals and nonprofit corporations; empowered federally chartered savings and loan institutions to make commercial real estate loans, consumer loans, and investments in commercial paper and corporate debt securities (up to 20 percent of assets); increased FSLIC coverage from $40,000 to $100,000; and authorized credit card lending and trust activities for federal savings and loans. DIDMCA did not allow thrifts, however, to make variable-rate mortgages or to deregulate their liabilities and offer market rate accounts. Thrifts, in order to

\textsuperscript{19} Mason, \textit{Bail-Outs}, 214.
“keep pace with the changing rate environment,” would have to use the “new lending powers” and diversify into “areas outside traditional home finance.”

The elimination of Regulation Q—legislatively mandated by DIDMCA—would eventually force thrifts to openly compete with commercial banks and other financial institutions for customers. Jay Janis, former Chairman of the FHLBB and President of California Federal Savings and Loan Association (one of the nation’s largest thrifts), speculated in 1981 that over the next few years “the number of savings and loan will decline, perhaps by as much as a third.” Even though many legislators and various business executives feared that DIDMCA would destroy the historic distinction between thrifts and commercial banks, Janis believed that “deregulation would fall far short of obliterating distinctions between banks and savings and loans.” The expansive powers of DIDMCA, according to Janis, provided thrifts with the “freedom to provide a full range of services in housing and family finance…at least for those that survive.” California Federal’s chief executive officer described the uncertainly of this new deregulatory environment best: “You either have to be gutsy or stupid to do what I’m doing…but we want to be the first to turn it around.” Many questioned why Congress would force thrifts’ management personnel into situations that encouraged and required such “gutsy or stupid” actions in order to survive, especially since individuals like Jay Janis were predicting that possibly close to one-third of the United States 4,622 savings and loan associations would fail within the next few years.

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21 Mason, Bail-Outs, 217.
23 Ibid. See also Robert Bennett, “Bank Law: Consumers’ Gains Cited,” NY Times, 2 April 1980. Bennett also pointed out that “many financial executives expect a large reduction in the numbers of individual institutions, but an increase in the services available from those that survive.”
The Wall Street Journal identified State Savings and Loan Association, a subsidiary of Financial Corp. of America, as the ideal thrift for this new deregulatory era. State Savings “aggressively” went “after the kinds of loan business that return a solid profit,” but these aggressive new practices, however, were described as “dangerous and unsustainable” by former savings and loan examiners. Nevertheless, during a year that most savings and loan institutions lost money, State Savings reported a 2 percent profit in 1980. This profit, no doubt, was enabled by their 24 percent interest rates that “socked borrowers.” Charles Knapp, Financial Corp.’s chairman, described other savings and loan managers—and their attempts to maintain Regulation Q—as “living in yesteryear,” and prohibited his staff from attending industry conventions for fear of their being “infected with S&L mentality.”

Thrift executives at State Savings projected to lend $1.3 billion in 1982, which 70 percent was expected to fund real estate development projects. This also meant that State Savings abandoned small savers and home buyers, “S&Ls’ traditional customers,” and the “traditional branch-office organization” of thrifts, because according to Knapp, “the small saver is gone forever,” which was exactly what some legislators, government officials, and financial executives feared would occur with thrift deregulation. Financial Corp. executives, in addition to shifting their professional gaze, also provided Porsche 928s as company cars, chartered Learjets for business trips, and paid large bonuses and benefits for attracting large depositors and closing loans, exemplifying many of the rapacious anti-working-class practices that would come to define the savings and loan crisis of the late 1980s. Deregulation, as the 1980s demonstrated, would not be without its causalities, and debates within Congress and the Reagan administration would eventually decide who survived.

Ronald Reagan’s Faith in Regulatory Relief

Reagan’s first year in office arguably “produced a set of changes in political-economic relationships so novel as to merit the denomination ‘revolutionary.’ The sobriquet, Reaganomics, is used…to emphasize the importance of President Reagan’s personal role in engineering great change.”

Deregulation clearly did not begin with Ronald Reagan. The fervency and ideological vigor to which his administration pursued economic deregulation, in addition to how they re-conceptualized thrifts as just another financial institution, certainly distinguished his deregulatory efforts from those of Ford and Carter, and in a sense, made him revolutionary.

Prior to the Reagan administration, regulatory agencies enjoyed relative autonomy in relation to Congress, the president, and cabinet appointees. Candidate Ronald Reagan campaigned, however, to address the “government problem.” Reagan “strongly believed that most social and economic regulations were unwarranted intrusions into the private sector.” Reagan believed the “entire spectrum of regulatory activity was open for examination,” which separated him from both his Republican and Democratic predecessors. Reagan’s ultimate goal was to “provide direct ‘regulatory relief’ to U.S. industry. Reform and repeal…existing regulations as well as…slowdown the initiation of future regulations.”

David Stockman, Reagan’s Director of OMB, before the inauguration even occurred, publicly declared the need for a “well-planned and orchestrated series of unilateral administrative actions to defer, revise, or rescind existing and pending regulations where clear legal authority exits.”

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27 Gerston, *Deregulated Society*, 49.
28 Quoted in *Deregulated Society*, 50.
The rigidity and narrow ideological aims of the Reagan administration’s deregulatory efforts was demonstrated by proposed responses to the savings and loan crisis specifically, and the instability of the financial sector more broadly. Reagan, only having been in office two days, created the Task Force on Regulatory Relief (TFRR). Headed by Vice President George H.W. Bush, the TFRR had three duties: to review major proposals issued by executive regulatory agencies; to assess existing rules; and to oversee legislative proposals to codify the president’s views regarding deregulation. In February 1981, Reagan issued Executive Order 12291, which sought to “reduce the burdens of existing and future regulations, increase agency accountability for regulatory actions, provide for presidential oversight of the regulatory process, minimize duplication and conflict of regulations, and insure well-reasoned regulation,” in addition to demanding a cost-benefit analysis for all newly proposed regulations.\(^9\) Whereas EO12291 shared some similarities with President Carter’s EO 12044, Reagan’s vision for deregulation was more meticulous and systematic than either Ford or Carter’s. The most radical aspect of EO 12291 was its designation of the Office of Management and Budget as the epicenter of regulatory control; OMB was given “unprecedented enforcement powers” to approve almost all new federal regulations.\(^30\)

Treasury Secretary Donald Regan epitomized an administration official fully committed to Reagan’s economic policies. Even before the economy recovered, Regan’s faith in the efficacy of competition and the efficiency of free markets justified his belief in Reaganomics. Hoping to provide “some prospective” on the new Administration’s economic policies, he addressed the Civic Federation in Chicago, IL in September 1981. Regan suggested that credit controls have “never” worked; they were an “inefficient substitute for the marketplace,” and

\(^{29}\) Gerston, *Deregulated Society*, 51.
\(^{30}\) Gerston, *Deregulated Society*, 52.
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needed to be rescinded. The United States needed less government, not more he said. Current regulations were costing taxpayers “billions,” and the degree of federal government involvement in regulating the economy directly “determines whether our economy will respond to the new climate of incentive or whether it will miss this rare opportunity and continue to stagnate.”

Regan’s declaration that regulation should not protect “special interests” signaled the end was near for thrifts’ government-protected market niche.

The secretary identified four fundamental problems—each intimately linked to Democratic regulatory efforts—that resulted from changes in travel, technology, and communications since the 1930s, which had drastically altered the United States’ financial system. First, interest rate restrictions—Regulation Q—forced banks and thrifts to borrow short and lend long, a practice now being called into “serious question.” Second, specialization—thrifts’ focus on mortgage lending—made it difficult for them to diversify their portfolios, which would spread risk and potentially limit losses during times of high inflation and interest rates. Third, the legislative ban on interstate banking and restrictions on branching ultimately “Balkanized our financial system.” The current system ran “counter to the nature of a modern financial service industry, Regan argued, because of these “artificial geographic restraints,” which limited competition and impaired efficiency. Fourth, the growth of regulatory agencies created an “inflexible” system with multiple regulatory agencies disseminating confusing and contradictory regulations. The “time has arrived to look carefully at all the current regulations” because a “national debate on this issue is overdue,” Regan concluded. To accomplish this, Regan proposed the Administration Task Force on Consolidation of Financial Regulatory

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31 Donald Regan, speech, House Banking Committee, Depository Institutions Amendments of 1982, 418.
32 Ibid, 420-29.
33 Ibid, 431.
Regan revealed his ideological and political motivations, however, when he rejected the creation of an “omnibus study body” because current proposals “would be put on hold pending the outcome of any commission/task force report” and as well because “policy positions already taken by the administration…would undoubtedly be opened up to needless and potentially counterproductive new debate.”

Regan compared the extant regulatory structure—“established in another era”—to “trying to fly a 747 by the seat of your pants.” The current financial system, he suggested, was “almost capable of flying itself,” a metaphor that demonstrated the administration’s belief in the self-regulating nature of markets as well as their attempt to reinforce that notion within American culture. Moreover, Regan’s quip that “the basic banking laws were passed” when “Charles Lindberg was flying the Spirit of St. Louis” cleverly portrayed Glass-Steagall, and the financial regulation it represented, as an remnant of a bygone era that must be replaced. Each of Regan’s four critiques attacked a critical component of the regulatory state, which built itself upon New Deal era legislation such as Glass-Steagall, McFadden, and the Home Owners’ Loan Act (1933). Regan’s rhetoric equated “old” with uncompetitive, inefficient, and primitive, ultimately presenting deregulation as the only logical solution for these “new,” complex problems.

Confirmation of Regan’s pro-market bias was not long in coming. William Poole, Cabinet Council on Economic Affairs member and Brown University economist, reminded Reagan administration officials in mid-1982 that they “may not in the end be skillful enough, and the electorate patient enough, to reverse in a permanent and decisive way the destructive policy

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trends of the last 50 years. It is, and will remain for some time, a close call.” Poole encouraged the Cabinet Council for Economic Affairs to remember,

For policy purposes all that is necessary is to accept the argument that markets work pretty well, especially as compared to the alternative of having Uncle Sam do it…It is essential to understand that in the context of expectational markets, market ‘rationality’ or ‘efficiency’ does not mean that the markets are especially successful in foreseeing the future. All that is meant is that the markets do not make easily avoidable mistakes. Moreover, Poole argued that “constancy of purpose and consistency of action” was necessary to change the “market’s vote” regarding long-term sustainability. “Impatience runs the clear risk of destabilizing rather than stabilizing market expectations,” Poole cautioned. “When events go our way,” Poole predicted, “economic recovery will cement a developing market view that this Administration has the correct policies and the guts to see them through.” The Reagan administration chose to follow its ideological commitment to deregulation, as Poole and Regan’s rhetoric implied, even though extant circumstances suggested such a course might well be imprudent, especially since interest and unemployment rates remained historically high.

To achieve the success Poole and Regan envisioned, the Reagan administration would have to dismantle significant parts of the New Deal regulatory state. The Cabinet Council on Economic Affairs (CCEA) identified four “broad areas of financial institutions reform” that would enable economic growth and reinvestment: product powers, liability powers, restrictions on geographic activities, and regulatory structure. These CCEA reforms—when enacted—would

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37 Ibid.
38 Poole’s rhetoric on “market votes” suggests a belief in a self-regulating market that is a rational, thinking actor that possesses all the requisite information to make the best decision possible. However, such a position fails to acknowledge how informational asymmetries (unknowable information to buyer), spillover/social costs (pollution, oil spills) public goods (education, infrastructure) and “rational irrationalities” (herding behavior) drastically affect the free-flow of the market. See John Cassidy, How Markets Fail: The Logic of Economic Calamities (New York: Farrar, Straus, and Giroux, 2009), 139-191.
39 Ibid.
fundamentally change the government’s role in regulating the financial sector. By November 1981, the administration had successfully incorporated many of its thrift deregulation proposals into S. 1720, the Financial Institutions Restructuring and Services Act (1981). Once S. 1720 went to mark up, the administration would “have a better idea…of the work left to be done on thrift institution powers and Glass-Steagall deregulation.”

Even though S. 1720 did not become law in 1981; its language was incorporated into Garn-St. Germain. The CCEA began to debate—“without the limiting consideration of whether a particular idea was ‘saleable’ politically”—the “optimal degree of concentration in the banking industry, federalism and the issues of state prerogatives, the appropriate pace of deregulation, the concept of the dual banking system and the safety of bank holding companies and their subsidiaries.” They eventually decided upon three proposals: to allow bank holding companies to acquire institutions on a national scale; to permit interstate branching within “natural market areas;” and to disallow electronic funds transfer terminals from being defined as “traditional brick-and-mortar branches.” All three proposals undermined McFadden’s prohibition against interstate banking; each was incorporated into Garn-St. Germain.

Disallowing further government protection for thrifts was another component of the administration’s assault on the New Deal regulatory apparatus. Richard Pratt, stanch deregulator and Reagan’s first Federal Home Loan Bank Board Chairman (the chief regulator for savings and loan institutions), contended that the cure for ailing thrifts “must come from the industry and not through government assistance.” Pratt’s insistence on thrift self-help, in addition to the eventual lifting of Regulation Q, marked a dramatic shift in the relationship between the federal

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41 Ibid.
42 Ibid.
government and savings and loan institutions. Thrifts could no longer afford to focus primarily on the mortgage market—a market niche created and sustained by the federal government. Not all thrifts agreed with these changes, as many feared they would “bankrupt scores of institutions already on the brink of insolvency.” Ailing thrifts, therefore, “sandbagged” new deregulatory changes throughout 1981 to protect themselves from failure.

Pratt argued that “defective structuring” was the “primary cause of the present economic vulnerability,” since particular “constraints” (Glass-Steagall, McFadden, and Douglas) had forced thrifts to “act in a manner inconsistent with the logic of the marketplace.” Congress, according to Pratt, needed to recognize “the reality” that the “old secure days of comprehensive rate control and rigid specialization will not recur, regardless of the future movement of interest rates.” DIDMCA was also to blame for this defective structuring, because it only deregulated thrifts’ liability side without providing them with any additional asset flexibility, a situation that proved “asymmetric and inherently unworkable.” Given these factors, Pratt believed Congress needed to expand thrift powers to meet these “new era demands.” Congressional deliberations over the appropriate response to this escalating savings and loan crisis centered, primarily, around the issues that made State Savings ostensibly successful: expansive holding companies, interstate banking, mortgage market protection, direct real estate investment, portfolio diversification, and risk management.

Debate over the Garn-St. Germain Depository Institutions Act

45 Ibid.
47 Ibid, 598.
48 Ibid, 595.
Many feared, by September 1982, that if Congress did not act soon, the thrift industry would collapse. The thrift industry recorded a $4.6 billion loss in 1981 and a $3.9 billion loss through the first seven months of 1982. Chairman Pratt indicated that at the end of 1981, 801 thrifts ($167 billion in assets) were at or below the legislatively mandated 3 percent net worth. During the first six months of 1982, the average cost of funds for savings and loan associations was 11.5 percent, while the average yield on their mortgage portfolios was approximately 10.3 percent. The FHLBB projected that if interest rates averaged 9.5 percent for 1982 and 1983—the first eight months of 1982 maintained an average of 12.3 percent—1,334 institutions ($324 billion in assets) would fall below the 3 percent net worth minimum.49

The debate over Garn-St. Germain raised fundamental questions about the characteristics that would not only define savings and loan institutions, but also the American financial sector of the future. The U.S. League of Savings Associations (U.S. League), American Bankers Association (ABA), Conference of State Bank Supervisors (CSBS), Independent Bankers Association of America (IBAA), Public Interest Research Group (PIRG), and the AFL-CIO all provided—what appeared to be—legitimate rhetorical justifications for either supporting or opposing financial deregulation. None of these groups’ concerns, however, were primarily motivated by preserving the status quo, or alternatively, furthering deregulation, because they believed in the “magic of the market.” And even though these interest groups presented evidence justified by historical precedent or the current economic crisis, each—save PIRG—interpreted S. 2879 through the lens of economic self-interest. The U.S. League supported S. 2879 because it incorrectly believed that the legislation was the thrift industry’s salvation. The ABA wanted the opportunity to offer new services that would allow for parity between commercial banks and

49 Ibid, 593-94.
“nonbanks,” and they believed their support for S. 2879 would earn them Congressional favor in 1983. The CSBS and IBAA wanted to prevent interstate banking because they doubted the long-term viability of state and local banking if smaller institutions were forced to openly compete with the massive bank holding companies that would inevitably result from deregulation. The AFL-CIO argued that S. 2879 ignored the credit-deprived working- and middle-class Americans who could no longer gain access to affordable housing. All of the arguments for or against S. 2879, and its potential effects on the dual banking system, regulatory oversight, deposit insurance, risk-management, the “special” status of depository institutions, and thrifts’ designation as America’s mortgage lender, therefore, offered nothing more than thinly veiled arguments to justify the government continuing to either protect already-established markets or to allow for new market expansion.

Paul Volcker’s conceptualization of the American economic tradition was incompatible with those of Ronald Reagan, Donald Regan, and William Poole because of Volcker’s willingness to use the Federal Reserve’s power to regulate aspects of the market. As Chairman of the Federal Reserve Board, Volcker argued that thrifts needed to maintain their housing specialization. Thrifts, Volcker argued, should be given more time to take advantage of the expanded powers provided by DIDMCA, since a little more than a year had passed since its passage. If thrifts eventually needed additional opportunities to expand, Volcker suggested that Congress consider keeping them “community, family-oriented institutions.”

Volcker did stress however, the importance of federal pre-emption regarding state oversight since it would be the FSLIC, FDIC, and Federal Reserve that would “deal with any adverse consequences for the

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The Federal Reserve envisioned four basic building blocks needed to maintain the integrity of the American financial system: the separation of banking and commerce; regulation of particular activities, not organizations; diversity among various financial institutions; and a public policy that protects the safety and soundness of depository institutions. Volcker argued, were the embodiment of a tradition in the U.S. that rests on concepts that concentration of economic power can be dangerous, that the potential for conflicts of interest in a service so vital as the extension of capital and credit should be minimized, and that there is a special public interest in the safety and soundness of our depository institutions—an interest that does not, and should not, extend in the same way to other businesses.

Volcker understood the positive and negative ramifications of the administration’s deregulatory policies. He feared, with a possible expansion of bank holding companies, that it would become difficult to insulate banks and thrifts from the “fortunes of other holding company affiliates.” For a number of reasons, Volcker recommended that Congress disallow banks and thrifts to sponsor and sell money market mutual funds. He maintained that it was “generally accepted that the new powers are of little relevance in relieving the existing (emphasis Volcker’s) earnings pressure on thrift institutions—indeed…the new powers could precipitate greater difficulties.” The Federal Reserve, ultimately, did not “perceive an absence of competition, or large new competitive opportunities, in the national, regional, or foreign markets.

53 Ibid, 617.
54 Ibid, 628.
55 Ibid, 630-32. Investment in money market mutual funds by banks, Volcker suggested, could change the availability of credit, potentially create conflicts of interest, impair the Federal Reserve’s ability to monitor the money supply, and ultimately, “weaken both our institutional structure and money control.”
56 Ibid, 635.
for commercial lending; indeed, there could be danger in looking toward those markets as a ‘quick fix’ for depressed earnings. Volcker, along with Henry Gonzalez (D-Texas) and Michael Edwards (CSBS), worried that the Reagan administration was using the thrift crisis and ‘budget emergency’ as a ‘Trojan horse’ to both sneak its deregulatory agenda through Congress and to justify inaction by the administration. Given memoranda that were circulated by the Cabinet Council on Economic Affairs, their concerns were justified.

The U.S. League revealed the extent to which thrifts envisioned a future—without Congressional restructuring—full of industry failure; deregulation was vital for their survival. Speaking on behalf of 3,800 American thrifts, the U.S. League suggested that ‘lofty and erratic interest rate movements’ were crippling thrifts, not ‘mismanagement and speculative interest’ (which was true for most thrifts in 1982). Thifts were victims of economic forces beyond their control; the thrift industry—in eighteen months—had lost one-fourth of its total net worth.

Savings and loan institutions, according to the U.S. League, “found it extremely difficult to

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57 Ibid, 637-38.
58 See Henry Gonzalez, prepared statement, House Committee on Banking, Finance and Urban Affairs, Subcommittee on Housing and Community Development, Effects of Budget Cuts and Deregulation on Low and Moderate-Income Groups in Cities, 97th Congress, 2nd sess., 13 Sept 1982, 3. See also Donald Regan, written statement, House Banking Committee, Depository Institutions Amendments of 1982, 644, Regan claimed that a “budget authorization this large and problematical at a time of budget stringency would be totally inappropriate. Also see Michael Edwards, written statement, House Banking Committee, Depository Institutions Amendments of 1982, 329. Edwards argued that it was not “right to pursue a public interest concern of an emergency type nature to use as a driver for legislation.”
60 Roy Green, written statement, House Banking Committee, Depository Institutions Amendments of 1982, 443.
61 Ibid, 442.
adjust to this new market-related and ceiling-free environment,” which subtlety indicated the ineffectiveness of DIDMCA.\(^6^2\)

The U.S. League highlighted thrifts’ unique historical role, which made “America a nation of homeowners,” and assured legislators that “in good times or bad, our institutions will remain the backbone of the residential credit markets.”\(^6^3\) It encouraged Congress to “enact broader and more flexible investment powers for thrift institutions so that thrift institutions might compete in a largely deregulated savings environment and work their way back to profitability,” which would “also relieve the need for an assistance program of indefinite duration.”\(^6^4\) The “future of our industry…depends upon successful enactment of the major provisions of S. 2879.”

The U.S. League supported federal pre-emption regarding due-on-sale clauses, continued FHLBB oversight on service corporations, and increased commercial loan capacity—in addition to offering commercial demand checking accounts—for thrifts. With the exception of sections 334 and 335 (which limited thrifts and holding companies from particular interstate actions), the U.S. League gave its “full support” to S. 2879.\(^6^5\) The U.S. League highlighted the essential role thrifts played in providing home ownership in the United States, ultimately amplifying their historic connection to their government-protected market niche, while simultaneously imploring Congress to fundamentally restructure their industry. Even though thrift executives offered Texas savings and loan associations as shining examples of deregulated thrifts maintaining strong ties

\(^{6^2}\) Ibid, 445.
\(^{6^3}\) Ibid, 451.
\(^{6^4}\) Ibid, 444.
\(^{6^5}\) Ibid, 460. Due-on-sale was the payment of the principal on the original loan at the time of sale. Several states, however, had placed restrictions on due-on-sale clauses, which either banned them altogether or allowed the new buyer to takeover the original loan without refinancing. This practice became increasingly problematic for ailing thrifts because it forbade them from forcing the new buyer to qualify for a mortgage at current market rates, possibly costing them even more losses. See also Ibid, 455-458.
to housing finance, on the whole, the post-Garn-St. Germain era witnessed a drastic decline in mortgage lending from savings and loan institutions.

The ABA, who represented more than 90 percent of the nation’s 14,500 banks, worried that Garn-St. Germain failed to address the “serious competitive inequality” between depository institutions in the United States. The ABA’s conditional support for S. 2879 hinged upon the passage of Senator Garn and Senator Riegle’s amendments and striking Title VI from the bill (which disallowed bank holding companies from selling insurance). It also supported extending capital assistance to struggling commercial banks. The ABA opposed the continued disparity between banks, thrifts, and “nonbank” banks. It acknowledged the historical precedent and importance of separating depository institutions and investment banking; however, the continued “invasion of outsiders intent on conquest” through mergers, new product development, and expanded thrift powers was unacceptable.

“Banks are profit-making institutions,” declared the president of the ABA. He also admitted that bank profits were shrinking due to inflation. Congress needed to care about banks declining profitability because the “banking community is the transmission system of the economy….Without new powers, there is the clear danger that this transmission system will get

67 Ibid, 477.
68 “Nonbank” banks were institutions that offered many of the services of banks, such as credit cards, consumer loans, and savings and checking accounts, but they did not belong to the Federal Reserve System and did not have a federal charter. They were problematic for thrifts and commercial banks because, often times, they offered savings and checking accounts that paid market interest rates, which meant customers began transferring funds from thrifts and commercial banks into nonbanks, a process known as disintermediation.
69 Ibid, 467-74. See also Letter, Charles Bruning to Donald Regan, 17 March 1982, folder Financial Institutions Reform Working Group (CM #149), box OA 9946, Edwin Meese Files, Ronald Reagan Library. ABA President Bruning expressed his disdain for an administration proposal that allowed for a .25 percent rate differential—advantageous to thrifts—on 91-day certificate of deposits that would hopefully “forestall the thrift industry’s drive for a massive bailout program.” He admonished Regan, declaring, “It won’t work. We cannot live with it and we will not live with it…we personally resent this political attempt to place the problems of the thrifts on our backs…you must reject this proposal.”
stuck in neutral. It needs an overhaul, and only Congress can do the job.”

Bank support for Garn-St. Germain was, ultimately, a quid pro quo for either inclusion in Garn-St. Germain or legislation in 1983 that allowed depository institutions to offer mutual funds and to underwrite municipal revenue bonds. The banks as a transmission metaphor, ironically, acknowledged the “special” status of depository institutions to justify the expansion of their lending powers and underwriting capabilities, thereby increasing risk for depository institutions and destroying the distinction between commercial and investment banks originally established by Glass-Steagall, all in the name of competition and profitability.

The CSBS, the “nation’s leading advocate for the state banking system,” told Congress to protect the dual banking system, which would be threatened if S. 2879 was passed. Any structural changes that occurred must respect the spirit of McFadden and Douglas, the quintessential glue holding the dual banking system together. CSBS argued that the “train of events set in motion by S. 2879 would lead to long-term concentration of financial resources and the demise of competition.” The CSBS rejected the idea that “New York bankers” could tell local financial executives “how we should allocate our resources.” Acquisition—the “road to growth”—led to “homogenization” and national conglomerates, and thus, the ruination of state banking. Local control and state regulation of local resources were the keystones of the dual banking system. Congress needed to decide, “To either reject homogenization or fully subject the

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70 Ibid, 469.
71 Ibid, 474.
73 Ibid, 329.
elements of the thrift industry seeking to become more bank like to State authority on questions of structure." CSBS’ testimony illustrated the inherent tension of the dual banking system—which supposedly respected states rights; however, state regulatory oversight of local funds required federal approval. Instead of giving more power to states, the dual banking system greatly enhanced the federal government’s oversight of the financial system, with federal legislators only delegating powers to states that it considered appropriate.

The FHLBB’s approval of interstate, inter-industry mergers increased the competitive advantage for these expanding bank holding companies and national banks. They also necessitated federal oversight because states had neither the resources nor the authority to regulate them, a lose-lose situation for locally operated thrifts and commercial banks. The IBAA agreed with CSBS, the dual banking system had worked successfully for fifty years, Congress should leave it alone. The inclusion of Title III in S. 2879, the IBAA argued, amounted to the eventual repeal of McFadden and Douglas. The IBAA warned that Title III would profoundly affect the “future financing of housing, on the future structure of our financial and economic system while promoting the concentration of the financial (and in turn political) resources of this nation, and on the historic ability of the states to determine the financial structure which best

74 Ibid, 220.
75 Robert McCormick, written statement, House Banking Committee, Depository Institutions Amendments of 1982, 400. The IBAA represented approximately 7,100 banks that met the credit needs of “small business, agriculture, and homebuilding in rural and suburban communities nationwide.” See also Edward Hill, “The Savings and Loan Debacle and Erosion of the Dual Banking System of Bank Regulation,” Publius 21 (Summer 1991): 32-33; and Frederick Balderston, Thrifts in Crisis: Structural Transformation of the Savings and Loan Industry (Cambridge: Ballinger Publishing Co., 1985), 8-24. Hill suggested that the benefits of the dual banking system were a “by-product of competition” between federal and state regulators for the “privilege” of chartering financial institutions. Dual banking supposedly encouraged innovation, which was a “response to new conditions in the credit markets,” allowed states to grant powers that exceed federal regulation, and exhibited the glorification of “community control” and “local responsiveness” of banks and thrifts. Balderston, on the other hand, argued that government regulations controlling chartering, branching, and exit—in the “context of service rather than price competition”—created an environment that allowed more financial institutions to exist than a “free-market process would have permitted.” More importantly, the dual banking system created a “competition in laxity,” resulting in a race to the least regulated entity between federal and state regulators, which only creates an environment where corporations, ultimately, have captured regulatory agencies. Lastly, Balderston opined, “The nagging presence of dual federal-state jurisdiction will prevent the creation of an administratively tidy regulatory apparatus.”
With its inclusion, industry executives feared that no institutional or structural mechanisms would force thrifts to continue financing the housing industry. Moreover, a democratic society, the IBAA believed, should be free from “excessive concentration of financial power,” reflecting a belief in Jeffersonian republican virtue and the need for checks and balances within the branches of government. Small businessman, small agriculture, American consumers, and even a majority of thrifts would suffer because of S. 2879, the IBAA argued. Only “established money centers and money center institutions will be among the few winners.”

Whereas the U.S. League, ABA, CSBS, and IBAA discussed the interests of consumers and small business owners throughout their testimony, ostensibly only PIRG and AFL-CIO represented the interests of the working and middle-class consumers, evident by PIRG’s description of Chairman Jake Garn’s “knee-jerk anti-consumerism” opposition to truth-in-lending requirements. PIRG argued Congress should mandate more thorough and consumer-friendly credit disclosure requirements (truth-in-lending), especially for cases of “seller

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76 Ibid, 400.
77 Ibid, 404. See McCormick, testimony, Depository Institutions Amendments of 1982, 552. McCormick argued that the only structural encouragement thrifts had to continue focusing on home finance was an IRS tax code. The President’s Housing Commission, he observed, recommended that code be modified if thrifts were deregulated. McCormick also noted, with the passage of Title III of S. 2879, thrifts could invest up to 60 percent of their assets in “non-housing activities” (403). See also Fred Napolitano, written statement, House Banking Committee, Depository Institutions Amendments of 1982, 369-71; and Harley Snyder, written statement, House Banking Committee, Depository Institutions Amendments of 1982, 245-60. Both stated that they had witnessed abuses within the industry and expressed concerns about the future state of home finance if thrifts were given expanded lending powers. They also argued that the government should continue to protect and promote the industry and its historic role as home building financiers. Snyder also feared that thrifts would use consumer loaning powers to offer more commercial loans, again, leaving less funds for home financing.
78 Ibid, 399. A belief in Jeffersonian republicanism also advocated for small government and local control, because any concentration of power, whether political or economic, produced an environment conducive for tyranny.
79 Ibid, 402.
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financing.” PIRG, agreeing with the IBAA, argued that the “combined effect of granting commercial banking powers to savings associations and permitting bank holding companies to acquire troubled savings associations on an interstate basis” amounted to a “back door repeal” of McFadden and Douglas. PIRG acknowledged the valid reasons for Glass-Steagall’s passage in 1933, and further elaborated, “Most of them are still valid today.” The problem for banks, PIRG suggested, was not interstate banking or regulation of “nonbank” activities; it was Regulation Q.

Portfolio diversification—the proposed solution to ailing thrifts and the basic thrust of S. 2879—essentially turned thrifts into commercial banks, PIRG argued, and further exacerbated the growing problem of thrifts providing fewer and fewer mortgage loans as a result of deregulation. PIRG also speculated that Chairman Pratt (FHLBB) was using the “thrift crisis as a vehicle to restructure financial institutions.” As such, Congress needed to limit the authority of the FHLBB and Federal Reserve to approve “cross-industry, interstate supervisory mergers.”

81 “Seller financing” was a homeowner receiving a second mortgage, often times through a real estate broker. Seller financing was problematic to PIRG because institutions were “qualifying” borrowers on their ability to pay “teaser” interest rates, leaving them to pay the principal at termination. If borrowers could not, then they either had to refinance the original loan—if they qualified at possibly a higher interest rate, or often times foreclosure occurred. As such, PIRG viewed these as anti-consumer and highly in need of regulation. See Brown, Depository Institutions Amendments of 1982, 538-39.
82 Ibid, 544.
83 Ibid, 554.
84 Ibid, 543. Brown stated that the “share of total assets invested in residential mortgage loans” had declined from 76 percent in 1979 to 68 percent by May 1982. If savings and loans were granted the “tax avoidance benefit” as proposed by Sec. 330 of S. 2879, Brown speculated that the extant tax incentives would not be strong enough to continue luring thrifts into mortgage lending. As such, thrifts should be subject to “minimum residential mortgage investment requirements” that are mandated by Congress. See also Mason, Bail-Outs, 226. In 1984, savings and loans—which grew less than 15 percent—held 68 percent of their assets in residential loans; however, institutions that grew by more than 50 percent only held 53 percent of their assets in residential loans. Also, whereas slower growing thrifts relied upon “traditional retail deposits” for 81 percent of their funds, the “highflying” thrifts only obtained 59 percent of their funds from local markets. Both of these factors demonstrate that, indeed, thrifts were focusing less and less on residential mortgages and continuing to distance themselves from their historic role as home financiers.
85 Ibid, 545. See Mason, Bail-Outs, 220-21, for a discussion of Pratt’s pivotal role in guiding S. 2879 through the legislative process, from drafting to passage, in addition to the measures he supported as a member of the DIDC and Chairman of FHLBB, such as “quick removal of rate controls,” liberalizing regulations, and allowing further
The AFL-CIO, like PIRG and IBAA, worried that the long-term effects of interstate and inter-industry mergers would create financial conglomerates that dominated and controlled the financial market to the detriment of locally owned banks and thrifts. It supported Title I and II of S. 2879, but not Title III. The AFL-CIO believed that Congress should allow instate, same industry mergers to rescue failing thrifts. It took “strong exception,” however, to “any merger or acquisition involving different types of institutions in different states,” because such transitions…facilitate the concentration of financial power, reduce competition and would be harmful to the economy.”87

The AFL-CIO believed that thrift restructuring “might save many of the thrift institutions, but it will not solve the fundamental dilemma of the housing market in which low- and middle-income families cannot compete for funds during the high interest rate periods.”88 It was the cost of funds, not just the availability of funds, argued the AFL-CIO, which determined interest rates and the size of the effective market demand.89 The “roller coaster pattern of residential construction over the years makes housing a relatively high-cost item, as the frequent, prolonged high unemployment for men and equipment has to be compensated for in good times.”90 The “sharp housing cycles” that the AFL-CIO identified were a “significant influence in causing the instability of economic recession followed by inflation, followed by recession, followed by inflation, ad infinitum.”91 The AFL-CIO seemed to believe that until working and middle-class Americans could attain affordable access to housing, the economy would continue

diversification. See also Richard Pratt, written statement, Senate Committee on Banking, Housing and Urban Affairs, The Credit Deregulation and Availability Act of 1983, 98th Congress, 1st sess., 12 April 1983, 39, for Pratt’s referral to McFadden’s anti-branching/anti-interstate banking restrictions as “anachronistic local restrictions.”

86 Ibid, 545.
87 Ibid, 663.
88 Ibid, 661.
89 Ibid, 663.
90 Ibid, 663.
to suffer because no structural change or capitalization efforts could ultimately save thrifts. This precarious position was highly unfortunate, given the significance the AFL-CIO assigned to thrifts—the United States’ mortgage lender of choice.

The Road to Perdition

The Reagan administration was replete with ideological conservatives that faithfully trusted in the efficacy of competition and the efficiency of free markets. Even within the inner sanctuary of the White House, however, one unlikely heretic—Edwin Gray—began to question the sanctity of deregulation.\footnote{Edwin Gray was an unlikely defector because he worked with Reagan for the better part of twenty years. He served as Governor Reagan’s associate press secretary from 1967-1972, and his press secretary from 1972-1973. He also campaigned for Reagan in 1976 and 1980. And coincidently, assisting the “U.S. League of Savings Associations in its efforts to encourage passage of the Garn-St. Germain Depository Institutions Act of 1982—after having resigned from the White House Staff,” was the only lobbying experience Gray reported on his “Statement for Completion by Presidential Nominees.” See Gray, Nomination Hearing, 6-11.} Edwin Gray replaced Richard Pratt as the Chairman of the FHLBB in May 1983.\footnote{Richard Pratt apparently indicated throughout his tenure as Chairman of the FHLBB that he would only serve for two years. See “Gray Tapped by Reagan as Bank Board Member,” Wall Street Journal, 18 February 1983.} At his nomination hearing on 23 February 1983, Gray discussed the vital role he played, as Reagan’s Director of Policy Information and Deputy Assistant to the President, in securing the passage of Garn-St. Germain. As a thrift industry veteran, Gray “recognized the growing need to lift the burden of many constraints which—while they may have served a useful public purpose in a previous era—were strongly and unfavorably affecting the thrift’s ability to compete effectively in the rapidly changing financial services environment.”\footnote{Gray, Nomination Hearing, 3.} In Gray’s opinion, the “flexibility” provided by Garn-St. Germain “enable[d] thrifs more effectively to weather future stormy seasons of economic instability, and not to be reduced to relative impotence in serving the needs of housing finance;” ultimately, it “must be acknowledged as one of the most significant and welcome events to occur in the history of the thrift industry.”\footnote{Ibid, 4.}
of the significance of Garn-St. Germain, unfortunately, would prove tragically accurate given the
legislation’s role in fostering the eventual colossal collapse of the thrift industry, a collapse that
required Congress to create the Resolution Trust Corporation in 1989 to oversee the $153 billion
liquidation of 1,043 thrifts.96

Even though Reagan administration officials believed Gray would follow in his
predecessor’s footsteps, he quickly revealed the limits of his deregulatory fervor.97 As early as
June 1983, Gray had written OMB Director David Stockman and Treasury Secretary Regan
expressing concern over the rhetorical justifications and structural implications of Treasury
proposals in the Depository Institution Holding Company Deregulation Act of 1983.98 Regan, in
a corresponding memorandum for President Reagan, both failed to incorporate Gray’s
recommendations and neglected to mention Gray’s concerns to the President. By October 1983,
Gray began publicly warning House and Senate committees, thrift executives, and fellow
regulators of the growing need for additional thrift examiners and the negative ramifications of
states’ loosening thrift oversight while simultaneously not demanding its own deposit
insurance.99 He also gave notice of the escalating potential for significant losses to the FSLIC—
increasingly due to ailing thrifts obtaining large brokered deposits.100 Even the U.S. League,
according to a 1983 FHLBB report, expressed “serious concerns over the current unregulated practices of deposit brokers,” which forced them to conclude, “The potential problems outweigh the benefits that might result from permitting the continuation of the current practices.” Gray attempted to limit brokered deposits to 3 percent of total assets in any given institution, but administration officials and judicial intervention thwarted those efforts.

Throughout 1983, administration officials stressed the importance of maintaining their deregulatory vigor. In response to Chairman Volcker’s 1983 proposed moratorium on thrift mergers, which Volcker suggested would provide time to thoroughly investigate the reasons for the continued financial instability, CCEA members “hoped to prevent adoption of a legislated moratorium on new depository institution activities that we believe would merely postpone indefinitely any Congressional deregulation of financial institutions.” This concern was explicitly expressed to President Reagan in July 1983, when both the Senate and House had produced bills proposing moratoriums, which could “stop all pressure for reform and simply be extended from year to year.” The memorandum to Reagan acknowledged that the administration had “agreed to introduce our Depository Institution Holding Company Deregulation Act at this time so that Congress can act on legislation that will have a positive deregulatory effect on the financial system…It is therefore essential that our bill be introduced as
Another CCEA working group demonstrated their faith in private enterprise by justifying their opposition to the recapitalization of the Federal Home Loan Mortgage Corporation (FHLMC) because it “would not move the FHLMC in the direction of a private agency.”

Not even five months after Garn-St. Germain was passed, FDIC Chairman William Isaac “shattered a 50-year tradition at a recent Senate hearing.” The FDIC chair, as precedent went, normally “calmly reassured lawmakers that all is well with the nation’s banks,” however when Isaac declared, “With the advent of deregulation…everything isn’t well with the nation’s banking safeguards,” he sounded the alarm. With a loss of federal power to adequately regulate financial institutions, a “tranquil banking system” could no longer be guaranteed. Isaac and Pratt—both staunch deregulators—acknowledged market controls, such as private deposit insurance, were needed to ensure that recently freed savings and loan institutions “act responsibly,” which suggested an implicit recognition that the potential for irrational behavior existed and the market was not as self-regulating as they believed it to be.

In 1983, Brent Beesley, the Director of the Federal Savings and Loan Insurance Corporation (FSLIC), speculated that up to 20 percent of savings and loan institutions “might run into trouble in the next year or so,” since Garn-St. Germain essentially gave them the “freedom to fail.” Others speculated that the “potential for such risky activities has risen because, under deregulation, nearly all banks and S&Ls can quickly get large volumes of deposits through brokers simply by offering above-market rates.” Both the FDIC and Comptroller of the Currency declared that their regulatory staffs’ needed “big increases” in order to regulate effectively;

105 Ibid.
however, Comptroller C. Todd Conover grimly conceded, “I don’t think we can afford a fail-safe banking system.” Combine Conover’s fears with Beesley’s prediction, “The strong will get strong, and the weak will get weaker,” and Reagan’s assertion that Garn-St. Germain was the answer to thrifts woes appeared less than certain.107

Paradoxically, when the administration was presented with clear-cut evidence that thrifts needed more oversight, nothing was done to supplement the understaffed needs at the FSLIC or to legislate new authority to its director.108 By June 1984, a CCEA report indicated that “up to 89 percent of the [thrift] industry’s aggregate regulatory net worth figure is made up of items not recognized as capital by generally accepted accounting principles (GAAP).”109 The thrift industry’s capital to asset ratios improved in 1983, but those improvements “reflected regulatory accounting principles, not GAAP.” The FHLBB had reduced the required net worth ratio in 1981 and 1982 because thrift losses had increased dramatically. To counter those losses, savings and loan institutions began— with the powers granted to them by Garn-St. Germain—“investing in loans that could increase their default risks.” Additionally, the CCEA declared that 48.9 percent of bank and thrift failures in 1983 occurred because of insider loans and internal fraud. Since the report also indicated that 44.3 percent of failures from 1980-1983 resulted from insider loans and internal fraud, the increase in 1983 should have demonstrated the importance of strengthening

107 Conte, “Regulators Say Banking Safeguards are Faulty and Need an Overhaul.”
108 See Memo, Thomas Healey to CCEA Working Group on Financial Institutions Reform, 18 June 1984, “Federal Deposit Insurance Study,” folder CCEA Working Group on Fin. Inst. Reform (2/2), box OA 10700, William Poole Files, Ronald Reagan Library. The memo states that when the director of the FSLIC resigned, he declared that he “did not possess the sufficient authority and control over personnel matter to discharge the Office’s responsibilities in a manner consistent with his personal standards.” Clearly, he was not in charge of his own agency.
109 Ibid. The report acknowledged that under GAAP, “goodwill, deferred loan losses and some other items would not be included in net worth.”
oversight. The workloads of examiners, however, mushroomed from $10 million in assets in 1981 to $120 million in 1984.110

The following month, a “Draft Review of the FDIC and FHLBB Reports on Deposit Insurance Reform” was circulated at the CCEA. The central issue addressed was the extent to which deposit insurance “subsidizes the high level of risk-taking that is possible in a less regulated market for financial services”—i.e. moral hazard. Both the FDIC and FHLBB concluded that, indeed, deposit insurance encouraged risk-taking. The report offered four proposals to help limit that risk: tying insurance premiums to some measure of risk; increasing risk exposure to large depositors; privatizing all or part of the deposit insurance system; or strengthening capital standards. The report interestingly acknowledged that enforcing capital requirements became “difficult or impossible to enforce without closing a large proportion of institutions in the industry,” highlighting the fragile state of affairs for thrifts, even twenty months after the passage of Garn-St. Germain. The report concluded that the administration’s solution to lowering risk was to propose and support “legislation that would require depository institutions to use separate holding companies to engage” in high-risk financial activities.111 A solution that hardly appeared concerned with reigning in and limiting institutions from continuing to perform obviously dangerous financial transactions.

Gray’s 1989 description that “financial deregulation took on some of the attributes of a narcotic” seemed appropriate to describe what appears—in hindsight—to be highly irrational

110 Ibid.
policy making. His identification of Donald Regan, among others in the administration, as “ideological crazies who cared more about their pet theories about the so-called [free] market than they did the taxpayers,” indicated the potency of their ideological fervor and the degree to which it ultimately guided and shaped the trajectory of deregulation as well as their solutions to the continued instability of thrifts. Gray’s claim that he was branded a “reregulator” by administration officials helped explain their calls for his resignation and only further demonstrated how their faith in deregulation blinded them to its ill effects, even in the face of mounting evidence that the industry was on the brink of failure. No wonder then, that the U.S. League was able to “gut” any and all regulations proposed by the FHLBB that it disapproved of; “it was thoroughly out of fashion to be reregulated.”

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113 “Bank Board Chief Said to Resist Resignation,” *NY Times*, 29 October 1985. A “well-placed source” believed Reagan’s Chief of Staff (former Treasury Secretary) Donald Regan “was behind the move to oust” Gray because of “turmoil in the industry.” No doubt neither appreciated the ideological fervor, or lack thereof, of the other, evident by their disagreement in 1983 over holding company deregulation. See also Monica Langley, “Troubled Bank Board’s Chairman Gray is Likely to Resign Soon, Officials Say,” *Wall Street Journal*, 28 October 1985.

114 Gray, *Savings and Loan Crisis*, 115. Gray described the extent to which the U.S. League was able to influence policy makers and legislation, which ultimately allowed them to continue stalling industry restructuring until the taxpayers would be forced to pay the bill.