Economist David Fand on the Thrift Crisis, Government Interference

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In the following interview, Fand

What restraints has the S&L crisis put on monetary policy? The problem used to be that when interest rates rose housing was affected immediately, because so much of the money for housing finance came through the intermediaries, which were operating under Regulation Q.

Fifteen years ago, before the secondary mortgage market made money available from more diverse sources, and while Regulation Q was still in effect, many people were concerned that monetary policy put a disproportionate burden on housing starts. They alleged that most of the impact of tight money fell on housing, while other sectors escaped with less damage. The issues today are different.

What are these issues ? The thrift crisis that we are dealing with now has actually been with us for 25 years. In a 1965 report to the government, I warned that institutions cannot readily convert liabilities payable on demand -- overnight money -- into 30-year loans. Yet Congress, which created the thrifts as we know them today, has continued to support this entire industry based on very short-term liabilities and very long-term assets. That's one issue. A second issue is whether weak and sickly thrifts should pay the same deposit insurance premiums as strong and healthy thrifts. Should we not question when someone running marathons and someone who has had three heart attacks pay the same life insurance premiums? Deposit insurance premiums are based on deposit volume, not on risk; that structure creates a problem of moral hazard. Another issue is interference by members of Congress. Their constant meddling and maneuvering promotes their own interests over the public good. We all know about former Speaker Wright and the Keating Five, but the problem is worse than that; those people are just the ones who have been on the network news. Politics has always played an important role in the thrift industry, and its regulatory agencies have been very politicized.

But is the industry more politicized than other sectors of the economy? To understand the nature of the thrifts' political problem, consider other industries. While the auto industry has a major impact on the economy, there are only a handful of companies to promote the industry's interests. However, when we talk about construction and housing and the related selling and financing activities, the clout of the thrifts is just the starting point. Add in 50,000 builders; they are a very powerful lobby. Then add the construction unions, with the backing of the AFL-CIO. Then add the Realtors®, with their lobbying muscle, and you begin to see the potent force that the thrifts have exerted for a long time.

Think about another type of financial institution, the money market mutual fund. Money market funds came into being in the 1970s as a result of disintermediation, which occurred when regulators continued to manipulate deposit interest rates to protect thrifts. The thrifts and their regulators thought they could hold down interest rates without losing depositors' money to other investments. Instead, their actions created a major new financial industry, with deposits that probably exceed all demand deposits in the U.S. New industries should come into being because the market recognizes a need, not because of ill-conceived attempts to protect other industries. The irony is that the S&L, with liabilities payable on demand and assets with 30-year maturities, is itself a creature that a market would not have generated.

The only way to avoid the kinds of problems we have experienced is to keep politics out. That is true not only with respect to housing; anything Congress touches becomes a problem that the rest of us pay for. Congress bungled the thrifts and Social Security, and now it may be damaging the health care system. We are facing

a problem of price controls in medicine today. The government is trying to keep down Medicare expenditures while letting the elderly believe that they're entitled to as much health care as they want. That costs a lot of money, so the answer from Congress is to control prices. The result is inevitably that the quality of medical service will deteriorate.

Housing is but one of many areas in which Congress has created problems by politicizing the issues, by telling voters they can have something for nothing. If we tell people that they are entitled to as much housing or medicine or child care as they want, if we tell them that things are free when in fact they are expensive, then we create the kinds of serious problems that we are observing today.

Without Congressional interference, firms and their customers would have to recognize risks. Institutions making long-term loans would presumably borrow long-term; if they issued bonds payable in thirty years, they could lend the proceeds under 30-year mortgages. Their balance sheets would be clean; they would be immunized against interest rate risk. On the other hand, if they wanted to attract short-term deposits, they would lend under variable-rate mortgages. Now, some people believe that institutions that borrow short can lend long, if they hedge with futures and options. I agree in principle that it can be done, but institutions doing this would have to be run by very accomplished money market experts, and I'm not sure that such experts are available to the thrift institutions on a mass scale.

Thus, if Morgan Stanley or another sophisticated investment bank wants to make mortgage loans financed with short-term liabilities, we shouldn't stop them. If they want to take those kinds of risks they should be allowed to do so. The trouble is that our mortgage lending industry has been organized so that managers can reap the gains if their risks pay off, while the taxpayer gets stuck if the managers strike out. If we want a viable system, we must restrict mortgage lenders either to raising their money through the bond market or, if they raise short-term money, to making variable-rate loans.

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You indicate that thrift problems have been with us for 25 years. Was the postwar period better for the industry? The '50s were spectacular for thrifts. The learned opinion of the day was that there was no future for commercial banks; the future "belonged to the thrifts." That idea was known as the *Gurley-Shaw Financial Intermediation Thesis.* Many articles published in the banking literature between 1960 and 1965 were written in the spirit of Gurley-Shaw. The thesis was that commercial banks would become an increasingly smaller component of the financial system, because other intermediaries had a big advantage over commercial banks. The theory was based on observations that during the 1950s the thrift institutions had grown very rapidly. But the theory's proponents had simply extrapolated trends of the '50s; there was no meaningful analysis.

The thesis was partly ideological, too, in that many people considered monetary policy to be old-fashioned. The name of the game at the time was fiscal policy, so the Gurley-Shaw Thesis was used to buttress the position that monetary policy was inappropriate as a stabilization weapon. The argument was that monetary policy operated on commercial banks, which were becoming a smaller part of the financial system, so the Federal Reserve Board was attempting to control a growing economy by operating on a shrinking part of the system. Therefore, monetary policy was inappropriate; therefore, we should have been emphasizing fiscal policy. Gurley-Shaw seemed to support the Keynesian view that monetary policy should not be used as a stabilization tool; that helped to fuel its acceptance. In retrospect, the Gurley-Shaw case was very weak; its success was probably based on the fact that it supported the prevailing fiscal policy ideology.

So the thrifts were already in trouble when Gurley-Shaw was gaining a wide following? By 1966, it was clear that the thrifts were in trouble. The most obvious signal was that year's disintermediation crisis. But let's look at the source of the trouble. Citibank invented the certificate of deposit (CD) in 1960 or 1961. It was a remarkable invention, a very powerful instrument that revitalized and revolutionized the commercial banks, enabling them to get money from wherever extra funds were available. By means of the CD market, a bank located where loan demand is strong can easily get money from other areas of the country. Commercial banks became very efficient when they

started using CDs. It is interesting that the inventors of the CD were the banks, not the thrifts. Instead of developing innovative ways to compete, the savings banks and S&Ls developed the innovative idea that every time they wanted something they could go directly to the government, or go indirectly through Congressmen. The commercial banks knew that they were not going to get anything from Congress, so they used the market.

It is ironic that when most academic writers felt we were entering the age of the thrifts, the banking industry invented an instrument revolutionary in its efficiency and marketability. The CD is a brilliant idea. A corporation with money available for 7 1/2 days can buy a 7 1/2 day CD. Commercial banks were innovating, while S&Ls were so secure in their reliance on Congress that creativity never occurred to them. Almost all the financial innovations of recent years have come from the commercial banks or the investment banks, not the S&Ls. The situation is almost on a par with the biblical theme of living and dying by the sword; thrifts were created by the government, they got government benefits, and they are going to die because they are so dependent on the government that they are unable to develop an original solution to the serious problems they face.

Can you elaborate on the impact the money market funds have had, both in the early 1970s and as time has passed? The money market fund made it obvious that Regulation Q could be outmaneuvered in the marketplace. The theory behind Reg Q, by which Congress limited interest rates paid on savings accounts, never made any sense. The stated intent was to protect the "little guy" from paying high mortgage interest rates by giving lenders a cheap source of funds. But the people with savings accounts were typically "little guys," too; wealthier people had access to more attractive alternatives, and Reg Q never applied to deposits of more than $100,000.

So we were hurting the little guy with a savings account by paying 5% on savings, at a time when inflation was 14%, in order to benefit the so-called little guy borrowing to buy a house. The trouble is that the person being deprived of a competitive return on savings had fewer resources than the person being helped on a mortgage; I believe that home buyers are wealthier than small savers. The depository institutions had a big lobby to preserve Regulation Q so they could continue to enjoy rate ceilings on small deposit accounts, and Congress justified the whole thing as a way to help the "little guy." But we really were not helping the little guy, certainly not the small saver.

If government guarantees were taken away, some thrifts would continue this very risky type of intermediation activity. Many of them would fail; that would be their privilege.

Would the thrift problems have been less severe under more normal economic conditions? If there had not been such high inflation ten years ago, the outcome would certainly have been different. Defects in a system appear when the system is exposed to stress. In the thrift crisis, the stress has been inflation. Even assuming a Reg Q ceiling, in the absence of inflation, nominal interest rates probably wouldn't exceed 4%, so a 5% ceiling would not be restrictive. But such a ceiling becomes ludicrous when inflation is 14%.

If we had not experienced double-digit inflation, the effects of any problems that occurred would have been spread over a much longer period. There were structural problems with the thrifts; many of the older S&Ls were just coupon-clipping organizations. They accepted deposit money, paid low regulated rates, and charged slightly higher rates on loans or bought government bonds; basically they did very little financial intermediation. An institution that operates in that manner is not a financial institution, in any significant sense.

What is the distributional effect of helping the thrifts, and why do liberals support these programs? The distributional effect is that we penalize small depositors. It is a serious penalty; if we pay 5% on deposits when inflation is 14%, we deprive the saver of $9 per year on a $100 account. Then we have the gall to tax $5 as income, when in fact the depositor has lost $9. Liberals don't worry about that; their line has been that the system is good for housing, so the little guy is helped. My guess is that liberals support anything that is "good for housing" because they go along with the trade union lobby, which has always been pro-housing because of the construction unions.

After talking about reforms since the early 1970s the government finally passed laws in 1980, '82, '87 and '89. What should these laws have looked like?
They should have been designed to create institutions perfectly matched in terms of duration: long-term borrowers lend long-term and short-term borrowers become variable-rate lenders. We could have accomplished these ends just by

taking away the government guarantees. Managers who cannot run to the government are not going to make 30-year mortgages with overnight money; in my world, if you make the wrong kinds of loans, you should suffer the losses. But S&Ls have not been afraid of that, because they could go to the Federal Home Loan Banks, or, better yet, send their Senators.

I would like to see a system of private financial intermediaries that raise their own capital and receive no government guarantees. There would be no reason for regulators to restrict the activities of such firms. But we need to strictly control the asset and liability powers of government-guaranteed depository institutions, limit them to holding relatively matched portfolios. Intermediaries that want government guarantees should expect restrictions on what they do.

Institutions should have operations that are relatively easy to manage in a risk sense. There are two easy ways to manage: one is to issue bonds and lend long-term; the other is to accept short-term liabilities and make variable-rate loans. Then there is a third type of management, found in what we might call sophisticated mortgage operations. These institutions should be run by managers who know the money market and the Eurodollar and Euroyen markets, and who know how to hedge. The large investment banks do that now, and they do it without government guarantees. Unfortunately, many S&Ls have tried to play the same game, but with taxpayers taking the risks. Most S&Ls haven't been sophisticated enough to be in that kind of activity, but a few were. If government guarantees were taken away, some of these thrifts would continue this very risky type of intermediation activity, and a few would do it well. But many would fail; that would be their privilege.

Should laws force insured thrifts to specialize in mortgage lending? Should the government play a role in deposit insurance? I don't think we should force people to do anything. If we leave them alone, some institutions will specialize. Problems arise when we give special benefits to mortgage lenders, but they decide that the accompanying regulations are too restrictive; they want to make commercial loans and still receive the benefits given to home lenders. If we don't give special treatment, if the rules reflect market discipline, then outcomes are fair and efficient. If government makes the rules, an institution with a friend in Congress may be able to obtain special privileges.

> *The worse the law, the more help a Congressman can give you in obtaining absolution from that law, and the more help he can then expect from you.*

A lot of the regulations we have today grew out of the Great Depression. Since that time there have been complex rules; the Federal Reserve has acted as a lender of last resort; and, of course, we also have deposit insurance. It would be ideal if the deposit insurance system could be managed without the government. But if the government has to be involved, I would like to see risk-adjusted premium pricing based on actuarial methods. Yet a simpler and even more important reform, one that would work wonders in terms of keeping the system honest, is mark-to-market accounting. We need honest balance sheets. A financial institution can value an asset at cost even though its market value has fallen by 50%. When we allow institutions to misrepresent their financial positions, we need an army of regulators to catch the misrepresentations. If institutions had to publish balance sheets based on market values periodically, we would not have to regulate so much; the market would provide the needed discipline.

Should the capital requirements be increased? People who talk about raising capital requirements want to continue government guarantees on the institutions' liabilities, so the capital question is one of protecting the government from losses. There should be as few government guarantees as possible. We could retain insured accounts for the small saver, who needs a savings outlet that does not expose him to risk, but institutions offering these accounts should be restricted to investing in low-risk securities.

Think of these banks, with taxpayer guarantees, as government-protected checkeries. Small depositors open transaction accounts, the institutions invest in Treasuries (or possibly AAA-rated bonds or commercial paper), the depositors earn small returns, and the government guarantees deposits. That limits the small depositor's options, but a small saver should not be investing in risky assets like real estate, and should not expect the high returns that only risky assets can provide. We have to separate the guaranteed deposit mechanism from mortgage lending. The secondary market has already brought that about to some extent; a lot of mortgages are being packaged and sold by the thrifts. I think the pension funds are pro-