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A Tale of Two Crises

William K. Black
University of Missouri - Kansas City, School of Law

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By **William K. Black**, University of Texas at Austin, LBJ School of Public Affairs
Visiting Scholar, Markkula Center for Applied Ethics, Santa Clara University

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About the Author: **William K. Black, Ph.D., J.D.**, was a federal regulator during the Savings and Loan Crisis of the 1980's. He has written and lectured extensively about criminal justice policy issues such as white-collar crime, financial institutions, savings and loan industry reform, public corruption, and public finance.

The savings and loan debacle of the 1980s was the worst financial scandal in U.S. history. The estimated present value cost to the taxpayers was $150-175 billion ($1993). The debacle was a major contributor to a sharp recession in real estate values in the Southwest. However, it had only a negligible effect on the *general* economy.

The Japanese economy, the second largest in the world, also experienced a crisis in the 1980s. Twin "bubbles" in its stock and real estate markets hyper inflated for most of the decade of the 1980s. In general, the bigger the bubble, the worse the ultimate effects on the general economy. When the bubbles burst in 1990 Japan was thrust into recession. Real estate values have continued to fall – for twelve years! The stock market collapse was equally sharp. The general economy has never recovered (though last quarter's revised GDP growth number may finally offer some faint hope).

One of the reasons the Japanese financial crisis proved so much more severe than the contemporaneous U.S. savings and loan debacle was the quality of leadership in the financial regulatory ranks in the two countries. Japan never produced a regulator willing to buck the powerful politicians and industry groups (banking, real estate and construction) that gloried as the twin bubbles inflated to obscene proportions and then, when they burst, covered up the resultant Japanese financial crisis. In fact, Japanese bureaucrats have endorsed and led the cover-up. As a result, its financial crisis remains severe twelve years after the “twin bubbles” (real estate and stock) burst.

Japan was filled with predictions in the 1980s that it would surpass the U.S. economy shortly after the turn of the century. Japan’s inability to deal with its financial crisis has shattered these expectations and created a deep malaise. As I write, the “reform” prime minister (of the unreformable Liberal Democratic Party (LDP)) is introducing yet another “stimulus” package of construction projects and naked government efforts to manipulate the stock market. (Japan uses vast sums in its many “off book” governmental entities to make coordinated stock purchases to inflate share prices.) The construction projects have covered much of Japan in concrete and nourished the LDP’s coffers through corrupt kickbacks. (Bid rigging on government contracts is Japan’s unofficial national sport. They have a word, “dango,” to describe the bid rigging among construction firms.) The government manipulation of the market helps explain why so few Japanese invest in the stock market. Between the government rigging the market and the traditional ethos of Japanese investment banking firms (customers exist to be fleeced), relatively few Japanese risk their savings to the mercies of the Japanese capital markets.

This explains why the Japanese postal system, which runs a vast consumer banking system, is the largest depository institution in the world. It doesn’t pay much in the way of interest (neither do the banks), but your deposits don’t lose 60 percent of their value. (Indeed, with deflation and yen appreciation, the return can be fairly good.) The postal system, not coincidentally, is also a leading source of LDP patronage jobs – with reciprocal contributions and aid to the politicians that secure the appointments of the local postmasters. The irony is that the postal deposit system, made massive by investors shunning the stock markets, is one of the largest providers of the funds used to manipulate the stock markets.

Of course, the more investors shun the stock market; the more it falls. Even before the ongoing falls in U.S. and world share values, Japan’s leading stock index, the NIKKEI, was only roughly 40 percent of its peak in the 1980s – and that loss of 60 percent continued for a *decade*. The drop in value from the peak NIKKEI average is now far worse. The LDP’s reaction to the drop in value is to increase the manipulation of the market. It reminds me of a poster one of my regulatory colleagues displayed: “The floggings will continue until morale improves!” Japan continues to flog its investing public and their morale continues to plummet.

A very large number of Japan’s financial experts earned advanced degrees in the U.S. They know that these policies are counterproductive and unworthy. They are contemptuous of the pervasive and persistent failures of the LDP leadership. There are copious academic articles opposing these policies; and some supporting efforts by top employer trade associations.

What Japan has never had, however, is a senior financial regulator who said “no” to the powerful. This may seem strange on one level, for Japan’s financial regulators had high prestige and were commonly brilliant. Until very recently, Japanese bureaucrats were accorded a status and positive reputation that was the opposite of the U.S. norm. The best and brightest graduates of Tokyo University’s law program went into the civil service. Tokyo U. is the top school in the country and is vastly more difficult to gain admission to than any U.S. school. Senior bureaucrats ran the ministries; the Members of the Diet who served as Cabinet Ministers were primarily ornamentation. It seems that Japan’s senior financial regulators were well positioned to provide superb leadership and take the painful, but vital, steps to limit and then clean up the financial crises.

But this optimistic view ignores cultural and institutional differences between the U.S. and Japan that make it all but inconceivable that a regulator would stand up to the powerful and impose the necessary painful remedies. Japan has a saying that “the nail that sticks up gets hammered down.” (This is not Western chauvinism; Japanese writers frequently cite this saying in explaining the nation’s ineffective response to recent crises.)

There are many institutional differences between the U.S. and Japan; I will focus on two. First, there was no real analog in Japan to the U.S. concept of an *independent* regulatory agency. The Ministry of Finance (MOF) was in charge of banking policy; it was intent on taking credit for the economic “growth” of the 1980s. In the 1990s its policy was to cover up the size of the catastrophe. All the largest banks were probably seriously insolvent on a market value basis because they invested so heavily in real estate and stock during the twin bubbles. Second, the senior MOF bureaucrats traditionally leave the government for a sinecure in the industry (where their primary job is to maintain good contacts with their MOF replacements). The poetic Japanese word for this practice is translated into English as “descent from Heaven.” The U.S. has an analogous concept (the “revolving door”), but the Japanese practice is far stronger and more pervasive. Both of these institutional factors reinforced the cultural pressure not to spurn the group consensus.

The current series of cover-ups by *CEOs* demonstrates that the desire to hide embarrassing news is a human, not a governmental trait. The many corporate officers who assisted abusive acts by their superiors shows that the disinclination to take on the powerful is also a common human trait.

But government officials are subject to unique temptation to cover up scandals for a variety of reasons. The primary reason is that neither they, nor *society*, consider their participation in a cover-up to be unethical. In particular, when you have only a few billion in the federal insurance fund to insure an industry that is, overall, insolvent by $150 billion; it is easy to rationalize that you have to lie to the public in order to prevent panic and a nationwide run on S&Ls in the United States. No regulator wanted to go down in the history books as the cause of the second Great Depression.

Government officials can also rationalize that the cover-up is a matter of loyalty to the president or party. Danny Wall, the top S&L regulator in 1987-89, explained that he hadn't really deceived Congress when he testified in 1988 that FSLIC did not need any taxpayer funds because every member of Congress knew he was speaking "in code." He claims that they all knew he couldn't tell the truth until after the presidential elections in November and that because they understood the "code" they weren't being deceived. Because they weren't really deceived, he wasn't really lying. Wall should be an important cautionary parable for all of us interested in ethical leadership. His parents raised him with high ethical precepts and he believed that he embodied those virtues. Wall came very close to becoming a pastor, carried a bible with him in his suit pocket and believed he was hyper ethical.

But Wall did not become a pastor; he became a congressional aide. Government accounting and budgeting is different from businesses for some valid reasons, but many of the deviations from normal principles exist for the express purpose of misleading the public for political gain. Their peers and bosses do not shun the congressional aides who commit these abuses. They are not defensive about their actions. The pervasive attitude in Congress is that it is a *game*. The best players at the game are praised and given more power. It is a game played with equal relish by both parties. There are periodic real efforts at reform. The Congressional Budget Office (CBO) exists because the Members of Congress knew that, left to their own devices, they were incapable of acting properly.

Government officials may also be more inclined to cover up scandals because they have greater ability than CEOs to block disclosure. They may classify the information, they may forbid access to underlying documents that could expose the misconduct on the grounds of executive privilege, and they may change the governmental accounting rules.

One of the nice things about America is that these efforts often fail. A great eye opener for me occurred when I presented a paper in Switzerland. My colleague and I decided that since we were in the land of bank secrecy we should meet with a Swiss white-collar criminologist who was an expert on bank fraud to get the inside scoop on Swiss banking abuses. The scholar we talked to was very kind – between gales of laughter. He said: “You don’t understand. This is Switzerland. It is illegal to disclose confidential information. *Those* laws, the police enforce vigorously. The only way we Swiss ever learn about Swiss banking abuses is when there is a prosecution in the U.S. and the facts come out. I read U.S. papers and go to the U.S. to learn about Swiss banks!”

The pervasive response to the S&L debacle was a cover-up. The Administration wanted a cover-up. Ronald Reagan was elected on a triple promise: he would cut taxes, increase defense spending and balance the budget. His budget director, David Stockman, would later admit that he knew the promises were incompatible and that he deliberately distorted reports (i.e., he lied) to hide this fact. The problem was that the S&L industry was federally insured and insolvent by $150 billion. If the Administration admitted that the deficit was really $150 billion greater than reported, it might not have been able to get the 1981 tax cuts through Congress.

Congress also favored a cover-up. If it admitted the deficit was $150 billion greater it would have to cut deeply other programs dear to constituents.

The S&L industry, represented by one of the three most powerful trade associations in America, the League of Savings Institutions (League) was all in favor of the cover-up. The federal and state S&L regulators, with no money to spend to solve the problem, favored the cover-up and perverted accounting rules to aid the deception.

Federal Home Loan Bank Board (Bank Board) Chairman Pratt, President Reagan’s appointee to deal with the debacle, appeared to be the right man, in the perfect place at the perfect time to deal with the S&L crisis. He was an academic; a professor of finance, whose area of expertise was the S&L industry. Pratt was the kind of leader that is praised in all those leadership books you find in airport bookstores. He came to a despondent agency. The Federal Savings and Loan Insurance Corporation (FSLIC) had only $6 billion in reserves. The S&L industry, by mid-1982, was insolvent by $150 billion on a market value basis. The situation appeared hopeless. Pratt roared into Washington, D.C. on his motorcycle, jumped off and strode into the Bank Board in his cowboy boots. He instantly energized the agency. Soon, the staff was working 12-14 hour days six or seven days a week to arrange *hundreds* of “goodwill” mergers. He drafted the key deregulation bill that became the “Garn-St Germain Act of 1982” and he “desupervised” the industry as well, cutting the number of examiners. He welcomed new entrants to the industry, revising the rules to allow a single individual to own 100 percent of the shares of an S&L. Hundreds of real estate developers entered the industry in response to this package of changes. By the end of 1993, the industry reported that it had earned a (slim) profit. Pratt left to run a Merrill Lynch unit that sold mortgage securities to the S&L industry.

But what Pratt had unintentionally done was create a perfect environment for fraud by controlling persons (control fraud). And the optimal control fraud was a “ponzi” scheme that required record growth. By 1983, every control fraud was reporting record (fictional) profits while becoming ever more deeply insolvent. The average Texas control fraud was growing roughly *100 percent per year*. Overwhelmingly, they invested in the same thing – the construction of new commercial office buildings. Soon, two things were true in the major Texas cities – record vacancy rates *and* surging property values. Those two things are not supposed to happen at the same time. This was a sure sign of a real estate bubble. At the rate the control frauds were growing, the bubble was inflating at a frightening rate and threatening to take the entire economy of the Southwest down with it when it burst. But Pratt was oblivious to this.

Pratt’s leadership skills were exemplary in many ways. He was extremely intelligent, creative, visionary, anti-bureaucratic, charismatic, quick, hard working and had a wicked, self-deprecating sense of humor.

Edward Gray became chairman of the Federal Home Loan Bank Board when Pratt stepped down. Gray’s management *deficiencies* were legendary. Meetings never began (remotely) on time. There were no meaningful agendas once the meetings began. Gray would abruptly leave meetings without explanation and might not return. He and his chief of staff, Shannon Fairbanks, would fight like an old married couple in front of the senior staff. Meetings took forever and wandered aimlessly. Bank Board departments communicated poorly or even worked at cross-purposes. There was no meaningful strategic planning.

Ironically, given his background as a specialist is public relations, Gray was an extremely poor spokesperson. Ever the journalist, he insisted on composing his own speeches at the typewriter and routinely stayed up until 4:00 a.m. to do so. The next day, looking pale and haggard, he would deliver a long, rambling speech that sounded to most listeners just like his last six speeches. He then sent copies of these speeches to every S&L. None of this would have gone over well in the best of circumstances. Following Pratt, a hero to the staff, made Gray's managerial deficiencies stark.

Within four months of becoming Chairman, however, Gray began to change those policies. Gray began to understand that the industry turn around to profitability was a fiction created by all the mergers and Pratt's Creative Regulatory Accounting Principles. In fact, the industry was deeply insolvent and losing tens of billions of dollars a year. He realized that the deregulation and desupervision of the industry at a time of mass insolvency guaranteed disaster under standard, conservative economic theory. He learned that the new real estate developers who were both CEO and controlling shareholder were primarily control frauds. The purported profits were fictional.

Gray learned these things because he listened. Roughly 18 folks reported directly to Gray and many others briefed him recurrently on what was happening in the industry. It made for an untidy organizational chart, but it meant that Gray heard many different views.

LISTENING AND LEARNING

Gray not only listened; he changed his mind in light of the facts. This proved to be one of his three great strengths as a leader. Pratt felt he knew what the problems and solutions were. He directed the staff. Gray began as Chairman sharing Pratt's views; but he modified them when he learned that they did not accord with reality.

But Gray's change of policies made him anathema to almost everyone powerful. He was saying that deregulation at a time of mass insolvency and with federal deposit insurance was a disaster. He was urging that deregulation required far more supervision, not less. He was saying that the highest priority of the Administration, Congress and the industry with regard to the debacle – covering up the vast scope of the insolvency through abusive accounting – was making the problem far worse. This was sure to enrage the Administration. Gray was about to become the great "reregulator," and that was heresy.

Gray also enraged the industry. They opposed reregulation, they opposed granting the supervisors any ability to use discretion and judgment and they opposed providing any more money to the deeply insolvent FSLIC.

Further, Gray faced the wrath of much of his own staff. Implicitly, he was saying that all of those long nights and weekends they had spent (at great personal and family cost) arranging the "goodwill" mergers and deregulating the industry were worse than useless – all their work had actually made things worse. Pratt had praised those efforts and given them bonuses. Who was Gray, so clearly Pratt's intellectual inferior, to denigrate their efforts? And Gray was not consistent. He fired a Bank Board economist for being one of the authors of a paper (*authorized* by the agency's chief economist) that (accurately) said that the FSLIC did not have enough funds. That action was indefensible and badly hurt Gray's reputation. (Calmer heads talked Gray out of going through with firing him.)

Gray faced great dissent among his colleagues. One Bank Board Member sought to replace him as Chair. Gray had to weaken seriously each of his proposed regulations in order to gain (reluctant) support from his two colleagues.

THE"VISION THING"

Gray's second great strength as a leader was (eventually) identifying the two key things that had to be done. Gray's most bitter opponents were the control frauds. Pilots have a saying: "speed is life." Growth is life for a ponzi scheme. Gray's single most effective rule was one restricting growth and increasing net worth requirements. That rule drove a stake through every ponzi scheme and assured that they would fail relatively soon instead of becoming vastly larger failures.

The other key was to dramatically increase the quality and quantity of the staff. Taking on this battle made the Office of Management and Budget (OMB) an even more virulent foe of Gray. It was a battle he won with persistence and creativity (for arcane reasons, he was able to do an end run around OMB by using the Federal Home Loan Banks). One of the keys was that Gray brought in extremely senior regulators from federal banking agencies. He did not surround himself with yes men and he personally recruited senior staff of exceptional ability (e.g., Joe Selby in Dallas and Mike Patriarca in San Francisco) who were used to regulating the nation's largest banks. Gray listened to and learned from these people and the examiners they hired and supervised. OMB responded by trying to kill Gray's efforts at reregulation and making a *criminal* referral to the Justice Department against Gray!

Together, the growth rules and the increase in the number and vigor of the supervisors stopped the ponzis and burst the horrific Texas real estate bubble. But bursting a large bubble, like lancing a boil, causes immense pain. The root cause of the pain, of course, is the infection, not the doctor's lance. But the bacteria that cause the infection are invisible while the doctor and the lance are all too visible.

The simile is inexact. While the bacteria are invisible, a boil is not. It is ugly, painful and clearly unnatural and undesirable. A "bubble" is the opposite. It appears to be quite wonderful to the participants. A bubble appears iridescent and wondrous to all that see it. Bubbles are magical; they appear to defy the laws of gravity (and the dismal constraints of economics). A bubble is a real estate *boom* or a record bull market. Bubbles always produce euphoria and maximize hedonism. A boom has a million friends. Those who point out that the boom is really a dangerous bubble have no friends. Those growing rich from a bubble sense its fragile, ethereal nature and fear that any unkind word may cause it to burst. No one caught up in a bubble wants it to end.

Adults are able to figure out that the doctor who lances a boil is not to blame. The pain is necessary to *their* cure. Delay will make things worse *for them*. (Even with this knowledge we often delay painful treatments.) Bursting a financial bubble helps society, but does not help the participants. They get the pain, not the gain. When a regulator causes immense pain to the powerful they do not thank him. When a regulator takes aim with his lance at a financial bubble he makes thousands of enemies and no friends.

The control frauds, which both caused and benefited from the bubble, proved to be Gray's most ruthlessly effective opponents. They marshaled all of Gray's other opponents into a coherent force to stop reregulation. Charles Keating, the worst of the control frauds, illustrates their power. Keating first tried to block reregulation by hiring Alan Greenspan as his economic consultant to attack the rules. He then got a *majority* of the House of Representatives to co-sponsor a resolution calling on Gray not to adopt a key rule. Gray went ahead anyway. Keating then hired the most famous civil litigator in America, Arthur Liman, to threaten to sue the Bank Board if it did not withdraw the rule. Gray refused. Keating tried, but failed, to hire Gray – offering to quadruple his salary.

The control frauds then tried to destroy Gray's reputation in the press. Gray's conduct gave them some useful ammunition. Gray was an odd combination of mildly venal and selfless. He lived in a Spartan apartment, with no car, on cheap frozen foods. He sent the great bulk of his salary to California where his wife and kids lived (she hated Washington, D.C. and would not live there). He left government service much poorer than when he entered – he had to borrow money from his mother. But Gray also headed a weird agency in which the Federal Home Loan Banks (FHLBs) were *agents* of the federal government but not government agencies. They were not subject to things like federal pay caps and they were financially strong. The FHLBs had long provided accommodations for Bank Board members when they traveled to monthly meetings with the FHLBs and the Bank Board General Counsel had opined this was legal. Gray's three problems were that the FHLBs gave him *great* accommodations (e.g., $500/night suites in the Waldorf-Astoria), he clearly liked it that way, and he traveled far more than his predecessors. Whether or not it was legal, it was wrong and it made Gray look bad. Gray's reputation took a serious hit. He was pilloried in the press as a fool. Though a high school valedictorian and college graduate, he was called "Mr. Ed" in print (after the TV show about the talking horse!).

Keating decided to try to get Gray fired. He hired a top lobbyist who reported the reasons this effort failed in an August 28, 1985 letter. The *Republican* lobbyist reported that while most top Administration officials wanted Gray gone, he enjoyed the loyalty of Nancy and Ronald Reagan, and: "like so many before him in this Administration, would have to be criminally liable or worse before they would be removed."

Don Regan, by now the President's Chief of Staff, then tried to force Gray to resign by leaking stories that the Administration wanted him to leave and that he would soon resign. Gray refused to leave.

Keating's Texas counterparts were equally busy attacking Gray. They used their extraordinary influence over Speaker Wright and the Bank Board's vulnerability to congressional extortion based on holding hostage the proposed legislation to "recapitalize" FSLIC (albeit with no taxpayer money). Passage of that bill was the Bank Board's transcendent priority in 1986 and 1987, so Gray gave in at first to Jim Wright's efforts. Ultimately, however, he decided that Wright simply increased his extortionate demands and that Gray's *duty* as Bank Board Chairman was to take on the Speaker and expose his conduct.

DUTY

It is this sense of duty that was Gray's third great strength as a leader. Some people get into conflicts because they are aggressive by nature, others because they are stubborn, and some because they are prideful and prickly. Gray was none of those things. He did not want to be in a conflict with the powerful. The strain of doing so took a dreadful toll on him. His hands shook, he aged terribly. And most of all, he *knew he would lose* and he knew his career and reputation would be broken. Most painful of all, he knew his friend Ronald Reagan, a man he loved, would not come to his aid. But he persisted. He thought very seriously about resigning, but decided it would be a dereliction of duty.

And what of Shannon Fairbanks, his managerially challenged chief of staff? She had a brain tumor removed and came back to the office three weeks later, the wounds still open, because she felt that was her duty. There is far more to leadership than management. Improbably, the nation was well served by the (apologies to Chris Berman) "stumbling, bumbling, rumbling" Gray Bank Board that *did* "go – all – the – way."

Ed Gray took on, *simultaneously*, much of the Administration, Speaker Wright, the Keating Five (the five U.S. Senators recruited by Keating to pressure Gray for favors), the League, his fellow Bank Board members, a number of the key staff and most of the press. He "lost" in most conventional senses. In a last, personally painful betrayal, Treasury Secretary Baker met secretly with Speaker Wright. They made a deal. Gray would not be reappointed Chairman, Wright would support the $15 billion FSLIC

Recapitalization, and the Administration would permit the "forbearance" provisions drafted by the control frauds to gut Gray's reregulation. Wright spoke in favor of the bill as promised, but his "whip," Tony Coelho, told the House Democrats that it was just for show and they should vote instead for a $5 billion bill. In the end, none of it mattered, for the League showed its lobbying power. In May 1987, a *majority of House Republicans*, including Trent Lott and Newt Gingrich, voted against the Administration! Democrats voted more than 2-1 in favor of the S&Ls. Some called it the May massacre.

But the *nation* ultimately won. Even though Gray's successor, Danny Wall, detested Gray and Gray's policies he failed to understand that the control frauds were frauds. He thought they were misunderstood entrepreneurs. As a result, he did not understand that his efforts to avoid closing them were doomed to failure because the growth rule was fatal to all ponzis. Wall succeeded in firing Selby. He removed Patriarca's jurisdiction over Lincoln Savings (after Keating showed that he had the support of both the Keating Five and Speaker Wright). But Gray had hired so many vigorous supervisors that all this did was destroy Wall's reputation and lead to his resignation in disgrace.

In the end, Gray proved the wisdom of William of Orange's motto about leadership in desperate circumstances. William led the fight for independence by the Netherlands and Belgium from what was then the most powerful nation on earth, Spain. He said: *"It is not necessary to hope in order to persevere."* Even though Gray's fears as to the personal cost that he would bear proved accurate, he remains glad that he too persevered. Japan's banking regulators placated the powerful and avoided personal ruin, but I cannot believe that they find looking in the mirror comfortable. Japan needed its own Ed Gray during the 1980s to lance the bubbles. It still needs an Ed Gray to end the cover-up. Indeed, the senior financial regulator was so dedicated to covering up the scope of the banking crisis that he refused to implement the prime minister's reform policies. He was finally fired in late September 2002 after refusing for years to clean up the banking crisis.

FOR FURTHER READING ON THESE TOPICS PLEASE SEE:

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