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The Savings and Loan Debacle of the 1980s: White-Collar Crime or Risky Business?*

WILLIAM K. BLACK, KITTY CALAVITA, and HENRY N. PONTELL

This paper examines the role of white-collar crime in the savings and loan crisis. Noting economists' assertions that crime was only a minor ingredient in the crisis, we compare the explanatory power of this "minimal fraud" model to that of its "material fraud" alternative. Bringing together evidence from every major study of thrifts in the 1980s, we argue that only the material fraud hypothesis can make sense of these data. This study demonstrates the utility of deductive reasoning in distinguishing between white-collar crime and ordinary business transactions, thereby potentially contributing to prosecutorial efforts, and helping resolve long-standing methodological dilemmas confronting white-collar criminologists.

I. INTRODUCTION

The decimation of the savings and loan (S&L) industry in the 1980s was one of the costliest financial debacles in U.S. history. The best estimate of the tab to U.S. taxpayers for this disaster, excluding interest payments for the government bonds sold to pay for the bailout, is $150 to $175 billion (NCFIRRE 1993a: 4). Despite the extensive government investigation of the crisis, as well as a spate of well-researched journalistic accounts, the role played by crime and deliberate misconduct is still hotly contested. Some government reports suggest that criminal activity or fraud were central factors in 70 to 80 percent of thrift[1] failures (U.S. GAO 1989a; U.S. Congress. House 1988: 51). Akerlof and Romer (1993: 39) calculate that 21 percent of the government's resolution costs are attributable to deliberate insider "looting" – a figure which they hasten to add is "likely to be an underestimate" of this single type of fraud. One federal thrift regulator argues that when both direct and indirect costs of fraud and misconduct are

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considered, they account for virtually 100 percent of the crisis (personal interview).[2]

Others insist that such claims are grossly exaggerated. This latter camp, mostly comprising economists and thrift industry consultants, contends that other factors were primarily responsible for the thrift insolvencies of the 1980s, with fraud playing a relatively minor role. While some point to the decline in oil prices and the collapse of the real estate market in Texas, most of these observers focus on excessive – but not illegal – risk taking and mismanagement as the principal culprits. Thrift consultant Bert Ely (1990: 2), for example, argues that ill-advised business decisions in the form of "the building of unneeded real estate, which then suffered a price collapse . . . added far more to S&L losses than did crime." Ely estimates that crime contributed a mere 3 percent to the cost of thrift losses (ibid.). Economist Lawrence White (1991: 117) devotes less than three pages of his recent book on the thrift crisis to "fraud and criminal activity" and claims that popular depictions have over-blown the "fraud factor." White argues:

> *The bulk of the insolvent thrifts' problems . . . did not stem from . . . fraudulent or criminal activities. These thrifts largely failed because of an amalgam of deliberately high-risk strategies, poor business judgments . . . , excessive optimism, and sloppy and careless underwriting, compounded by deteriorating real estate markets.* (Ibid.: 117; emphasis in the original)

Similarly, financial commentator Hobart Rowen (1990: H1) contends that "fraud and high living . . . account for only a small share of the huge losses," the bulk of which he attributes to excessive risk taking and lack of expertise with the new investment opportunities opened up by deregulation.

Over forty years ago, Tappan (1947) fired the opening shots of a parallel debate among criminologists. Criminologists, he warned, had been distracted by a new "fashion," according to which subjective criteria such as "socially injurious conduct" were supplanting legal definitions of crime. While recognizing that the convicted population is not necessarily representative of all law violators, and that law itself is a cultural and political product, nonetheless Tappan (ibid.: 100) argued that criminologists must confine their study to those who have been "held guilty beyond a reasonable doubt of a particular offense." Otherwise, "[t]he emancipated criminologist reasons himself [sic] into a cul de sac" (ibid.: 97), in which the absence of objective yardsticks "invites individual systems of private values to run riot . . ." (ibid.: 100).

For Tappan, white-collar crime scholars were the worst offenders. According to Tappan (ibid.: 98):

> the currently fashionable dogma of 'white collar crime' . . . is actually a particular school among those who contend that the criminologist should study anti-social behavior rather than law violation.

White-collar crime, he contended, is therefore "the conduct of one who wears a white collar and who indulges in occupational behavior to which

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some particular criminologist takes exception" (ibid.: 99). Conflating the issue of what constitutes law and criminal behavior in the first place, with the separate issue of how representative the processed population of offenders is, Tappan had set up a dichotomy (see also Burgess 1950; Caldwell 1958; Orland 1980). Either we rely entirely on the criminal justice system to determine who is criminal, or we must resort to hopelessly subjective value judgments of social injury.

Sutherland (1945: 1949) responded to such criticisms by pointing out that if we ground our studies on the well-documented biases of the criminal justice system, we inevitably perpetuate those biases and lose all claims to science. As Geis (1992: 36) puts it:

> Sutherland got much the better of th[e] debate by arguing that it was what the person actually had done in terms of the mandate of the . . . law, not on how the criminal justice system responded to what they had done, that was essential to whether they should be regarded as criminal offenders.

Indeed, it was one of Sutherland's major contributions to underline the folly of relying on criminal convictions to define the population of offenders, given the differential ability of higher-status individuals to evade the criminal justice system.

Most criminologists today eschew Tappan's narrow definition of crime as only that which has been labeled as such by the criminal justice system, as well as his derision of the concept of white-collar crime. However, an analytical and methodological dilemma remains unresolved for white-collar crime researchers. Given the intrinsic difficulties of uncovering and successfully prosecuting white-collar crime, how *do* we locate the offending population, establish its size and characteristics, and study its dynamics?[3] This difficulty is reflected in the current debate over the extent of savings and loan fraud. Some insist that criminal convictions must serve as an approximate indicator of thrift fraud; others, pointing to the difficulties of detection and prosecution in this complex area – and the fact that when prosecutions do occur only the easiest to prove thrift crimes are charged – argue that criminal convictions constitute the proverbial "tip of the iceberg" (Federal Bureau of Investigation, personal interview). For the criminologist undertaking this particular "case study," the debate is not an idle one; for, while 3 percent of thrift losses due to fraud might be accounted for by greed or other individualistic qualities, the far larger estimates of other observers suggest the possibility of a "criminogenic environment" (Needleman & Needleman 1979). For the public official recommending regulatory reforms to avoid future banking debacles, the resolution of the debate may also be critical.

This paper has three primary goals. First, it represents an attempt to contribute to this debate, evaluating systematically the evidence for large-scale misconduct and fraud as significant ingredients in the savings and loan crisis. Second, in so doing we intend to demonstrate the utility of the scien-

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tific method and deductive reasoning in coping with the dilemma outlined above. We thus reject the dichotomy posited by Tappan and his colleagues – counterposing a reliance on criminal justice definitions of crime on one hand and the slippery slope of subjectivism on the other – by suggesting a third alternative: the use of deductive logic and available data to infer criminal misconduct. Specifically, we evaluate three rival hypotheses regarding the primary motivations of managers at failed thrifts: excessive risk taking, mismanagement, and fraud. Each of these hypotheses would predict certain objective behavior that can be tested far more easily than subjective intent. We then compare these predictions with the evidence from existing studies of savings and loan losses. We conclude that current data support the hypothesis that fraud was a major contributor to S&L losses in the 1980s.

A third set of goals is more practical, related to regulatory and prosecutorial efforts and future policymaking. As regulators and prosecutors wrestle with ways to detect and prosecute wrongdoing, this analysis may contribute to the effort to distinguish between deliberate misconduct and legitimate business transactions. In the absence of clear paper trails or evidentiary "smoking guns," it is often difficult to construct an effective legal case for misconduct despite sometimes extensive circumstantial evidence. A thrift, for example, may have accumulated 99 percent bad loans arranged under suspicious circumstances; yet, without persuasive direct evidence of fraudulent intent, conviction is unlikely. This article suggests that it may be possible to demonstrate fraud through testing the null hypothesis. In the attempt to ferret out deliberate misconduct from ordinary business failures, such deductive reasoning may be a powerful regulatory and prosecutorial tool.

This article has policy implications as well. For, if the thrift debacle was primarily the consequence of risky business gone awry, then preventive policies might include an increase in capital requirements and perhaps risk-based insurance premiums; if the primary culprit was managerial incompetence, the focus might be on more rigorous licensing requirements to ensure minimal levels of competence. If, however, deliberate misconduct and insider fraud propelled the thrift crisis in significant part, more aggressive enforcement and control mechanisms must be put in place to prevent comparable disasters in banking and similar financial institutions. More fundamentally, the perverse incentives to fraud – almost limitless asset powers combined with generous deposit insurance and illusory accounting techniques – must be replaced by structural restraints. Any future experiments with deregulation must eschew ideological approaches and include a realistic appreciation of the potential for fraud and deliberate misconduct.

Before proceeding, some descriptive background on the savings and loan crisis will be helpful. The following section outlines key ingredients of that crisis, concluding with a general discussion of the difficulties of detecting

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and labeling business crimes, and the specific complications of unraveling fraud in financial institutions.

II. DESCRIPTIVE BACKGROUND

The savings and loan industry emerged from the Great Depression as a protected (federally insured) feature of national housing policy. Savings and loans were permitted to make long-term, fixed-rate home loans. They had few competitors in this business and the economy and government kept interest rates low and stable. After World War II, pent-up demands for housing from the long depression and war years combined with a baby boom and federal housing policies to produce a record expansion of housing. The thrift industry became extremely profitable, and the government added to these cartel profits by restricting the interest rate banks could pay their depositors. With thrifts allowed to pay higher interest rates, they grew rapidly to meet the burgeoning demand for home finance.

The end of stable interest rates in the late 1960s gradually began to reverse the thrift industry's fortunes. Since thrifts had extended hundreds of billions of dollars of thirty-year, fixed-rate loans (often at 6 percent), and they were forbidden to offer adjustable-rate mortgages ("ARMs"), thrift profitability declined rapidly as interest rates climbed. By the mid-1970s, the industry was insolvent on a market value basis (that is, based on the current market value of its assets rather than on their reported book value). With inflation at 13.3 percent by 1979, and with thrifts constrained by regulators to pay no more than 5.5 percent interest on new deposits, the industry found it virtually impossible to attract new money. When Paul Volcker, head of the Federal Reserve Board, tightened the money supply in 1979 in an effort to bring down inflation, it sent interest rates to their highest level in this century and triggered a recession. Faced with defaults and foreclosures resulting from the recession, and increased competition from high-yield investments given the hikes in the interest rate, S&Ls hemorrhaged losses. By 1982, on a market value basis, the industry was insolvent by $150 billion (NCFIRRE 1993a: 1), while the Federal Savings and Loan Insurance Corporation (FSLIC), the federal insurance fund for thrifts, had only $6 billion.

At this juncture, ideology combined with political convenience to set the stage for the thrift debacle of the 1980s that cost the taxpayers over $150 billion.[4] Deregulation was the rage among economists in this era, regardless of their political affiliation. After all, the ban on ARMs had played a critical role in the interest rate crisis. With "over"-regulation thus discredited, and a financial crisis underway, the political grounds were ripe for substantial thrift deregulation.

In 1980, the Depository Institutions Deregulation and Monetary Control Act began to phase out restrictions on the interest rates that savings and

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loans could offer to attract new deposits. Two years later, the Garn-St. Germain Depository Institutions Act accelerated the phaseout of the interest ceiling and relaxed restrictions on the investment powers of savings and loans. The bank board and the administration devised the act and offered as the primary basis for its adoption a study by bank board economists documenting the success of Texas-chartered thrifts that the state had deregulated in the 1970s. With the passage of the Garn-St. Germain Act, federally chartered thrifts were authorized to offer consumer loans of up to 30 percent of their assets, make commercial, corporate, or business loans, and invest up to 40 percent of their total assets in real estate ventures. In addition, the act allowed thrifts to provide 100 percent financing, requiring no down payment, in an effort to attract new business to the ailing industry. California legislators, afraid that state-chartered thrifts would shift to this deregulated federal system, reacted by almost completely deregulating California thrifts.

In this context, thrifts that wanted to grow massively (many grew by 100 percent a year) could do so by simply offering higher interest rates to depositors. The health of the thrift was irrelevant to depositors as long as they kept their individual deposits within the $100,000 insurance limit. Because capital requirements were also reduced by deregulation, not only were rapidly growing thrifts investing in high-risk assets, but they had fewer capital reserves to cover potential losses.

Because thrifts were insolvent on a market basis in the early 1980s, they were cheap and easy to acquire, particularly since the bank board – desperate to attract new capital – had eliminated the old prohibition against closely-held thrifts.[5] Real estate developers flocked to the industry, especially in Texas and California, where thrifts were almost completely deregulated. One of these developers, Charles Keating, tried to recruit a CEO to run his newly acquired Lincoln S&L by telling him that a California charter was "a license to steal" (NCFIRRE 1993c: 46). Indeed, deregulation seemed to have set the stage for entrepreneurs who had never been in banking to take over thrifts and use federally insured deposits to invest in whatever scheme they desired.

By 1986, FSLIC had closed so many insolvent thrifts and reimbursed their depositors that the agency itself was declared bankrupt (U.S. Congress. House. 1989a: 286). Unable to cope with the magnitude of the crisis by the mid-1980s, FSLIC was forced to slow the pace of closures, even as the number of insolvent thrifts continued to climb. A study by James Barth, former chief economist for the Office of Thrift Supervision, reveals that between 1980 and 1988, 489 thrifts reported losses of $42 billion while continuing to operate after insolvency (Brenner 1990: H1). In 1989, savings and loans lost a record $19.2 billion (Rosenblatt 1990: A1). In the first two months of 1990, thrifts continued to report losses of billions of dollars, almost matching the record reported losses of the previous year (Johnston 1990a: D8). It was not until 1992, with fewer than half of the nation's thrift

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institutions remaining in business, that the industry showed signs of recovery.

By the late 1980s, criminal referrals of suspected wrongdoing in thrifts began flooding the Department of Justice, and by 1990 close to 7,000 such referrals had piled up (U.S. Congress. House 1990b: 98).[6] With an infusion of resources provided by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Justice Department's financial fraud efforts accelerated. By 1992, over 1,100 defendants were charged in major savings and loan cases, and 839 had been convicted, with 77 percent receiving a prison sentence (U.S. Department of Justice 1992b: 64).[7] Hundreds of investigations and prosecutions are still in progress.

According to a Senate Banking Committee memorandum, a large number of these crimes were committed within some variation of four types of business transactions: land flips, nominee loan schemes, reciprocal lending arrangements, and linked financing (Alt & Siglin 1990; for a description of these transactions as vehicles for thrift fraud, see Calavita & Pontell 1993). Many of these transactions involved acquisition, development and construction (ADC) loans, to be discussed at length below. Although the variations on these basic themes are limited only by the confines of the imagination, they all have a number of things in common. They involve insiders in decision-making positions; they closely resemble ordinary business transactions; they can be endlessly embroidered so as to leave an intricate paper trail with which to confound regulators and investigators; and, finally, the deregulated environment within which thrifts operated was central to this fraud and the paper trails disguising it.

Addressing the complex nature of such cases, one FBI agent specializing in thrift fraud discussed the time required to investigate a single case: "I don't know any case that has taken less than six months, and some have taken three years. The really big cases – two or three years" (personal interview). Another explained:

> When it comes to these insider, conspiratorial things, they are extremely complex, they are disguised. . . . The problem is figuring out what the crime is. What did they do? How did they do it? And then can I explain it to a court of law, to people who are high school graduates or less? You know, I spent I think about five and a half months where all day, everyday, I sat in a room with boxes and boxes of records . . . To figure out what's happened in these things is really tough. (Personal interview)

A vast literature addresses the difficulties of detecting white-collar crime and convicting its perpetrators. Much of this literature points to the abundant resources with which corporate offenders are able to secure expensive legal counsel (Coleman 1989; Levi 1981), and the status identification of some judges with defendants of similar class backgrounds and social standing (Clinard & Yeager 1975). More fundamental, however, as Katz (1979) and others (Levi 1981; Ogren 1972; Tillman & Pontell 1992) have noted, white-collar crimes are often well-disguised by the complex

business transactions within which they are woven. Indeed, the difference between a crime and ordinary business activity often rests on the issue of intent – a subjective state notoriously difficult to ascertain. In the case of banks and thrifts, a wide array of professionals is available to affirm the routine status of transactions. For example, thrift operators rarely needed to bribe an appraiser in a fraudulent loan scheme. Instead, they could simply pick those who had a reputation for providing high appraisals and then supply them with the appraisal value necessary to support the intended loan. If the appraiser cooperated, she got the thrift's lucrative business; if not, she was branded as overly conservative among like-minded thrifts. In this scenario, intent to defraud is virtually impossible to ascertain and prosecution unlikely.

Related to this issue of intent, financial institution fraud of the sort involved in the S&L scandal is often extraordinarily complex. As one FBI investigator put it,

> It took the [thrift] regulators a while to explain to me what they were doing, and the regulators said it took them a while to figure it out too. You have a [Charles] Keating. Keating said, "You don't understand my land deals and my junk bond deals." [David] Paul [owner of defunct CenTrust Savings and Loan in Miami] said, "You don't understand my junk bonds." (Personal interview)

It was in this context that the debate over the extent of deliberate fraud and crime in the thrift industry emerged. Citing the difficulties of investigation and prosecution, limited resources, and anecdotal accounts of extensive insider abuse, a wide range of regulators, investigators, journalists, and social scientists conclude that the actual amount of thrift fraud extends far beyond the numbers formally charged and convicted. This account has a ring of truth to it, particularly for those working within the white-collar crime tradition; however, many economists and thrift consultants who blame the insolvencies on mismanagement or risky business practices emphatically reject it. The remainder of this paper evaluates these rival interpretations of the role of deliberate fraud in the thrift crisis. While it can never be known with precision what percentage of losses were due to crime and fraud, our purpose here is to use deductive reasoning to tease out its relative primacy.

III. THREE RIVAL HYPOTHESES

A. DEFINING THE TERMS

Bank and thrift fraud can be pursued either criminally or civilly. Criminal bank fraud requires the prosecution to show "beyond a reasonable doubt" that the defendant acted knowingly and willfully to defraud the bank in violation of criminal statutes. Civil fraud – usually involving regulatory violations such as the breach of the fiduciary duty of loyalty – reduces the

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plaintiff's burden of persuasion to "a preponderance of the evidence." While technically distinct, there is considerable overlap in these two levels of culpability. Indeed, the substantive elements of the crime and the tort of bank fraud are identical, only the burden of persuasion differs. Moreover, in the banking context, a wide spectrum of misconduct is subject to criminal prosecution, because of the pervasive importance of federal deposit insurance and the opportunities and risks it accords. Thus, knowingly giving false financial information to a bank or thrift to obtain a loan is a crime; knowingly keeping false books and records is a crime; and, knowingly providing false information to regulators is a crime; often, breaches of the fiduciary duty of loyalty are crimes.

Because of this overlap in elements, and because for our purposes the key is whether the misconduct is intentional, not the relative persuasive strength of the prosecutor's case, the term "fraud" is used here to include criminal and civil fraud as well as deliberate insider abuse. It should be emphasized that this is due not to a lack of definitional rigor, but to the reality that in practice they converge.

B. THE DEBATE

Two schools of thought have emerged on the issue of how significant a role fraud played in the U.S. savings and loan crisis. The "material fraud" school is composed primarily of regulators, law enforcement officials, the U.S. General Accounting Office (GAO), and investigative journalists. In their examination of thrift failures, members of this camp conclude that material fraud or insider abuse were present in essentially all the catastrophic insolvencies. The GAO (1989a), in a study of the twenty-six most costly thrift failures, found that fraud and insider abuse contributed to every one of the insolvencies, with a total of eighty-five criminal referrals having been made against 182 people, primarily officers, directors, or shareholders. Charles Deardoff (1991), deputy regional director of the Office of Thrift Supervision in San Francisco, conducted a study of all the Office's Eleventh District (California, Arizona, and Nevada) S&Ls from 1984 to 1988; he found fraud and insider abuse in 67.6 percent of thrifts that were taken over after insolvency. Pizzo, Fricker, and Muolo (1991: 453) studied fifty failed thrifts and concluded, "[s]windlers, mobsters, politicians, greedy S&L executives, and con men capitalized on regulatory weaknesses created by deregulation and thoroughly fleeced the thrift industry." The Resolution Trust Corporation (RTC), the federal agency established in 1989 to manage and sell the assets of defunct thrifts, estimates that 60 percent of the thrifts under its conservatorship were "victimized by serious criminal activity" (Lowy 1991: 160). The National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE) (1993a: 4) found that in "the typical large failure . . . [e]vidence of fraud

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was invariably present. . . ." There is general consensus within the material fraud school that deregulation in the early 1980s opened up unprecedented opportunities for fraud, while federal deposit insurance protected depositors from risk (removing their incentive to exert private market discipline), and thus assured a steady stream of capital to even the most fraudulent and precarious institutions.

The "minimal fraud" school, on the other hand, comprises primarily economists who disdain what they see as the "anecdotal" approach of material fraud proponents. Economist and former Federal Home Loan Bank Board member Lawrence White (1991: 117) argues that "any treatment of the S&L debacle that focuses largely . . . [on] . . . fraudulent and criminal activities is misguided and misleading." James Barth concurs, "If there was so much fraud, why are we just hearing about it today?" (Thomas 1990: A2). Thrift consultant Bert Ely (Hector 1990: 84) contends, "A lot of what people are calling fraud is a combination of stupidity, bad judgment, and desperation dealing." Robert Litan (1993: A10), Brookings Institution economist and member of the National Commission on Financial Institution Reform, Recovery and Enforcement, similarly downplays the role of "greedy wrongdoing" in the thrift crisis, arguing instead that the debacle resulted from excessive risk taking and the collapse of the Texas economy. Banker and lawyer Martin Lowy (1991: 161) states categorically that outright fraud did not sink S&Ls; rather, "[inflation] and imprudent lending decisions caused all but a relative few of the failures." Finally, Robert Samuelson (1993: A21) maintains that it was not "sleaze" that caused the thrift scandal, but inflation, followed by deregulation and "reckless" investments. These economists argue that we need not go beyond straightforward economic theory into the underworld of con men to explain the thrift crisis. Noting that the thrift industry was already in disarray by 1980, they posit that rational businessmen, "gambling for resurrection" through the risky investment vehicles provided by deregulation, simply lost the gamble.

Implicit in this minimal fraud argument are two kinds of causal factors: excessive risk-taking and managerial incompetence. While usually cited together, and frequently interrelated, for analytical purposes we can pose two distinct "minimal fraud" hypotheses based on these respective factors. The following sections present these two hypotheses with their corresponding predictions for objective behavior, and contrast them to the third hypothesis positing substantial material fraud.

One of our goals is to make explicit the implications or "predictions" that derive from these minimal fraud hypotheses. Despite the apparent rigor of economic theory, the excessive risk-taking hypothesis has been elaborated by its economist proponents in only the most general terms; the incompetence hypothesis has been discussed in an even more cursory fashion. By systematically stating these hypotheses and their logical predictions or implications, we intend to facilitate their analysis and make them testable.

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We derive the predictions that correspond to these hypotheses through deduction by extending the logic of their economic paradigms. Our task is made easier by the extensive economic and finance literature premised upon rational, wealth-maximizing actors. The predictions we delineate thus flow logically from this conventional economics paradigm, upon which these hypotheses are purportedly based. Having laid out the predictions, or implications, of these hypotheses, we then test them against the empirical facts of the thrift crisis, focusing on the worst thrift failures of the 1980s.

We draw the empirical data from a wide range of government studies, statistical analyses, and interview material. Among the most important of the studies we use here is a U.S. General Accounting Office (1989a) investigation of the twenty-six most expensive thrift failures of the mid-1980s, which at the time accounted for 60 percent of FSLIC's costs. Other data are drawn from the final report of the NCFIRRE (1993a); a study of forty of the worst thrift failures in Texas (U.S. Congress. House 1989a: 576–95); a Federal Home Loan Bank Board analysis of California thrifts (ibid.: 524–72); a thrift industry study conducted by James Barth (1991), former chief economist of the Federal Home Loan Bank Board; an extensive statistical study of the relationship between thrift fraud and ownership types, by Office of Thrift Supervision economist Charles Deardoff (1991); and, interviews conducted by authors Calavita and Pontell together with their colleague Robert Tillman, with one hundred thrift regulators, investigators, and prosecutors across the U.S.

The next section provides a systematic exploration of the three rival hypotheses and their implications, followed by a discussion of the empirical facts of the thrift crisis, and finally, an evaluation of the relative explanatory power of the minimal fraud versus material fraud models.

C. THE HYPOTHESES

1. *Hypothesis No. 1: Excessive Risk Taking*

> *Thrift owners and managers were rational profit maximizers. Given the state of their insolvent institutions in the early 1980s, managers took on technically legal, but very risky investments in the hopes of extraordinary returns that could rescue their thrifts from bankruptcy. The thrift debacle of the 1980s resulted from the collapse of these excessively risky investments.*

This hypothesis is directly related to the economics and finance concept of "moral hazard." Moral hazard characterizes a wide variety of situations in which perverse economic incentives are created. Most commonly, this occurs when individual actors stand to benefit, with no personal risks

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attached, from engaging in activity that over the long run and at the collective level is inefficient or counter-productive.

In the context of thrifts during the early- and mid-1980s, this kind of moral hazard was acute and close to universal. It was universal because virtually every thrift was insolvent on a market value basis, and thus had nothing to lose from further potential losses (since they would be taken over by FSLIC in any case), and much to gain from any windfall profits (which were the only hope of reversing their substantial insolvency). As financial experts Benston and Carhill (1992: 2) observe, "thrifts with zero or negative net worth . . . have nothing to lose from investing in high-variance [high-risk] assets . . . ." The moral hazard was acute because the overwhelming bulk of thrift "creditors" were federally insured depositors who continued to place their insured deposits in insolvent thrifts. Federal deposit insurance, in conjunction with the deregulation of interest rates and asset powers, provided thrift managers with a steady stream of insured deposits with which to invest in any endeavor they saw fit. For the owner or manager of a financially strong thrift, moral hazard is contained by the fact that a failed long-shot gamble may thrust the thrift into insolvency, wipe out the owner's substantial capital in the thrift, and cost the owner her job; for a thrift that is already insolvent and thus stands to be taken over by FSLIC, there is no such countervailing force.

Now, the more insolvent the thrift was, the more extraordinary the profits needed to be for the owners to come out ahead. Such extraordinary profits, if financial markets are even mildly efficient, can only be obtained by investing in extremely risky assets that have very high default rates. Thus, according to the "gambling for resurrection" model, rational economic actors had a perverse incentive to engage in ever-riskier behavior if their initial gambles failed, much like a casino gambler who "doubles down" (see, e.g., Brumbaugh 1988: 45–69; White 1991: 39–42). According to this hypothesis, the failure of most of these high-risk gambles, which were rational from the point of view of an individual thrift manager with nothing to lose, accounts for the bulk of thrift losses in the mid-1980s. As with all moral hazard, the individual actor (thrift owner) had a powerful incentive to engage in behavior that at the collective level produced devastating results (the collapse of the industry).

It is important to point out here that the "risks" associated with this kind of "gambling" are negligible from the point of view of the thrift itself. For an insolvent thrift, there is nothing to lose and everything to gain from a series of long-shot gambles. The "risk" refers only to the fact that the particular investment is a long-shot. For insolvent thrifts gambling for resurrection, the odds of these "gambles" are: "heads I win; tails you (FSLIC) lose."[8]

If this "excessive risk taking" hypothesis is accurate, then by logical deduction and by extension of the underlying economic paradigm, we should expect to find the following:

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(a) *Types of Institutions*

The owners most susceptible to this kind of moral hazard would be those whose institutions were deeply insolvent (i.e., those who had little chance of reversing their insolvency in the absence of exceptional profits from high-risk investments). Furthermore, the more insolvent the thrift, the riskier the investment would need to be to permit the (long-shot) possibility of exceptional returns sufficient to bring the thrift out of insolvency. Second, excessively risky investments and subsequent losses should be greater at stock associations than at mutuals. According to finance theory, "mutual managers tend to be more risk averse" compared to stock association managers (Benston & Carhill 1992: 2). This is particularly true in the case of insolvent thrifts. While mutuals are technically "owned" by their depositors, instead of dividends they receive a guaranteed rate of interest on deposits, which – because of deposit insurance – are secure regardless of the financial state of the thrift. In contrast, shareholders of a stock association stand to gain through stock appreciation and dividends if the gamble succeeds; for insolvent stock associations, such high-risk ventures are entirely rational, and in the best interest of their shareholders, who have lost their capital investment unless some long-shot gamble can save them. Third, losses would be greatest at state-chartered thrifts in states that allowed their S&Ls to invest in the riskiest assets, most notably California and Texas.

(b) *Nature of Investments*

According to this "gambling for resurrection" hypothesis, losses would be concentrated in thrifts where managers engaged in high-risk investments, because of the high default rates of such investments. In addition, thrifts that were unsuccessful at initial efforts at resurrection, if not closed down by regulators, would grow rapidly through more and more high-risk investments, in an effort to "hit the jackpot" and stave off collapse. Further, the hypothesis would predict that thrift managers would diversify in a range of risky investments. Portfolio diversification theory holds that such an investment strategy increases expected returns of the overall portfolio, compared to investing in only a few asset categories. Brumbaugh (1988: 77–79), Barth (1991: 96–97), White (1991: 113–15), and other proponents of the gambling for resurrection hypothesis explicitly draw from this finance theory to explain why rational economic actors would diversify their portfolios. Only a few "plungers" would concentrate their high-risk investments in a handful of assets, since this further decreases the already limited possibility of success with high-risk investments.

(c) *Controls and Underwriting*

Rational owners pursuing resurrection would use extreme care in underwriting assets that carry higher than normal credit risks, such as junk

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bonds, unsecured loans, or loans requiring no down payment. As Lowy (1991: 33) explains, "Recovery takes extremely good management and even better luck. There's no margin for error." High-yield investments carry substantial intrinsic risk; however, good underwriting can reduce some of these risks.[9] The larger and more intrinsically risky the project, the more critical is superb underwriting. Underwriting is viewed as essential even on small loans at healthy thrifts where the consequences of error are minimal. When one's only chance of resurrection is in picking a successful high-risk investment, the incentives for good underwriting are significantly enhanced. Even risk-loving "plungers" would seek to avoid controllable risks through underwriting.

Similarly, strict internal controls would be established for the purpose of detecting fraud and incompetence, since they are fatal to efforts at resurrection (Benston & Kaufman 1986: 60). Finally, rational profit-maximizers pursuing resurrection would exhibit at least minimal responsiveness to regulators' concerns regarding underwriting and internal controls (but unresponsive to concerns regarding the inherent risk of their investments); after all, correcting for these deficiencies would significantly enhance the chances of profitability. Even the most "anti-regulatory" (honest) thrift managers would respond proactively to the discovery by regulators of fraud and inadequate underwriting in their institutions.

(d) *Pattern of Success or Failure*

The preceding predictions have been cast at the level of the individual thrift, but the gambling for resurrection model also generates important macro-level predictions about the collective fate of the thrift industry. For example, if the model is accurate, thrifts should have had a significant measure of success gambling for resurrection in the 1980s. While they were starting from a deficit in that they were market-value insolvent in 1979–83, interest rates fell sharply in late 1982 and most of thrifts' unrealized market losses were eliminated by the mid-1980s. Moreover, some markets in which the putative gamblers were very active, e.g., real estate and junk bonds, produced robust returns through most of the 1980s. Had well-intentioned thrift investors enjoyed even minimal success in a diversified portfolio of high-risk assets, they should not have consistently failed. Indeed, there should be a material number of highly successful gambles. Among those who gambled and did fail, we would expect a wide distribution in the scope of those failures, from minor to catastrophic.

2. *Hypothesis No. 2: Managerial Incompetence*

Thrift failures in the 1980s were primarily due to managerial incompetence. Deregulation permitted individuals with no previous banking experience to buy and operate thrifts, at the same time allowing them to

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make a wide variety of risky investments with which they had little or no prior experience. The epidemic of thrift failures was the predictable result of this lack of experience.

A number of predictions follow from this "managerial incompetence" hypothesis.

(a) *Types of Institutions*

First, stock associations would have a greater incentive than mutuals to secure expert management and hence avoid failure, since stock value and dividends in stock associations – but not deposit interest in mutuals – vary considerably with profitability. Furthermore, shareholders in stock institutions have the means to act on this incentive by determining the composition of the board of directors. Such institutions could also offer stock incentives to attract expert managers. Thus, one would expect that if the "managerial incompetence" hypothesis is accurate, thrift failures would be concentrated among mutual associations. Second, if failures were caused by a lack of managerial expertise, we would expect to find such failures concentrated in states that allowed for nontraditional investments requiring sophisticated financial skills; fewer failures would occur in states that limited thrifts to traditional activities, such as making home loans. Third, failures should be disproportionate among institutions that had undergone a change of ownership, particularly if the new owners and managers had little previous experience relevant to the nature of their investments.

(b) *Nature of Investments*

Following the "managerial incompetence" hypothesis, we would predict that insolvencies and losses would be associated with nontraditional investments with which thrifts had little expertise prior to deregulation. In addition, some inexperienced thrift managers might unwittingly concentrate too heavily in certain investment areas, contributing to poor asset diversification.

(c) *Controls and Underwriting*

Inexperienced managers might engage in inadequate underwriting and establish weak internal controls. However, one would expect even inexperienced managers to conquer the most basic aspects of underwriting; further, underwriting and internal controls should improve over time with experience. The "managerial incompetence" thesis would also predict that inexperienced managers would be responsive to regulatory and supervisory concerns regarding underwriting, internal controls, potential regulatory violations, and the general safety and soundness of their investments.

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Indeed, well-intentioned but inexperienced managers would welcome such supervisory advice.

(d) *Pattern of Success or Failure*

According to the managerial incompetence hypothesis, thrift failures would be numerous and costly following the entrance into the industry of novices with little or no prior experience; we would, however, expect the frequency and scope of failures to decrease with time as thrift owners who entered the field in the early to mid-1980s gained experience.

3. *Hypothesis No. 3: Material Fraud*

Fraud and deliberate insider abuse were central factors in the thrift crisis of the mid-1980s. Not only did fraud contribute to many of the insolvencies of the period, but it was a key ingredient in the most costly thrift failures.

This "material fraud" hypothesis would predict the following.

(a) *Types of Institutions*

If fraud and misconduct were a major cause of thrift failures and losses, we would expect to find these failures concentrated in deregulated states that allowed for the nontraditional investments within which thrift fraud could easily be disguised. Second, we would expect these nontraditional investment activities to be concentrated in thrifts that were insolvent on a market value basis. With little to lose, these "zombie" institutions would be ripe for fraud. Third, if deliberate insider abuse and fraud contributed substantially to thrift losses, these losses should be disproportionate in tightly-held stock associations rather than mutuals, where ownership and control are more widely distributed. In addition, it is likely that failures and losses would be disproportionate at thrifts that experienced a change of ownership immediately preceding the flurry of nontraditional investment activity and associated losses. This is so because we would expect that, given the potential rewards, many individuals would seek to enter the industry to commit fraud. This would particularly be true of entrants with substantial conflicts of interest, e.g., real estate developers.

(b) *Nature of Investments*

If this "material fraud" hypothesis is accurate, we would expect losses to be concentrated in thrifts that engaged in nontraditional investment activities, such as acquisition, development and construction lending and other direct investments that provide ideal vehicles for fraud. We would also expect

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little portfolio diversification, since a manager committing deliberate insider abuse is likely to invest in those assets that best facilitate fraud, to collaborate with a more or less limited network of associates on the outside, and in any case to be not particularly interested in moderating long-term risk. Following the same logic, we are likely to find many loans at, or exceeding, the loans-to-one-borrower (LTOB) limit. Finally, thrift managers engaged in deliberate abuse would be likely to trigger a period of rapid growth. This is so not only because rapid growth maximizes the value of the fraud, but also because the investment vehicles within which fraud takes place – such as large development loans – require a rapidly growing portfolio of reported assets to camouflage the fraud.

(c) *Controls and Underwriting*

This hypothesis predicts that underwriting would be weak or nonexistent, since proper underwriting in a context where there is fraud would expose that fraud to regulators who subsequently examined the files. Further, senior managers engaged in fraud would have both the ability and the incentive to undo any internal controls that might obstruct their ability to perpetrate the fraud.[10]

Fraudulent managers would also be resistant to supervisory or regulatory action; indeed, they would attempt to deceive regulators, covering up their fraud and concealing the deteriorating financial health of their institutions.

(d) *Pattern of Success or Failure*

We would expect material insider fraud to lead almost invariably to failure, frequently catastrophic failure. Furthermore, failures and losses would be well in excess of the intrinsic (i.e., non-fraud) risks of thrifts' high-risk assets.

IV. SUMMARY OF FINDINGS

A. TYPES OF INSTITUTIONS

All of the research reported by the National Commission on Financial Institution Reform, Recovery and Enforcement (1993: 53; see also Deardorff 1991; Tillman & Pontell 1992) concludes that stock associations were far more susceptible to failure than mutuals, and that their losses far exceeded those at mutuals. Further, losses and insolvencies were heavily concentrated in the most deregulated states, in particular Texas and California. Texas, which in the early 1980s was considered the model for deregulation, incurred by far the most failures and the costliest insolvencies, followed by California, which by 1983 had enacted comparable permissive deregulation. According to the GAO (1989a: 92), there were 284 official thrift failures

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between 1985 and 1987, with forty-six located in Texas and thirty-seven in California (Illinois was third, with seventeen). Of the twenty-six most *costly* failures studied by the GAO, twenty were in state-chartered institutions (ibid.: 25), ten were located in Texas, and eight were in California (ibid.: 93). Fully 95 percent of problem thrifts in Texas by the mid-1980s were state-chartered (U.S. Congress. House 1990a: 230). The regional pattern remained constant for the rest of the decade; of the thrifts placed in Resolution Trust Corporation (RTC) conservatorship in 1989, four times as many were located in Texas as in any other state, with Texas accounting for an overwhelming proportion of thrift assets in conservatorship, followed by California (RTC 1989: 12).

Failures also predominated among thrifts that underwent an ownership change in the early 1980s. Regulators report that change in ownership was one of the principal "red flags" marking the worst failures (personal interviews). Of the twenty-six failures studied by the GAO (1989a: 15), 62 percent had experienced a change of control in the period preceding the insolvency. More generally, of the seventy-two thrifts placed in government conservatorship between March 1985 and July 1987, approximately one-half were managed or owned by individuals who were new to the thrift industry (Strunk & Case 1988: 89). In California, of the twenty-six state-chartered institutions that failed and were turned over to FSLIC between 1985 and 1987, twenty-one were either new institutions or had recently changed management (U.S. GAO 1989a). A report of the Texas Savings and Loan League reveals that real estate developers entered the Texas thrift industry en masse in the early 1980s and that by 1987, "own or owned 20 of the 24 deeply insolvent thrifts in Texas . . . ." (U.S. Congress. House 1990a: 449–50).

B. NATURE OF INVESTMENTS

Virtually all of the thrifts that experienced the worst failures invested in high-risk assets, particularly acquisition, development and construction ("ADC") loans. In their study of the twenty-six most costly thrift failures, the GAO (1989a: 17) found, "All of the twenty-six failed thrifts made non-traditional, higher-risk investments", with nineteen engaged in high-risk ADC lending. An examination of the thrifts taken over or closed in 1988 revealed that they held more than twice the national average of high-risk direct investments (U.S. Congress. House 1990a: 608).

High-risk investments and corresponding losses were associated with explosive growth, leading the GAO (1989b: 9) to conclude that thrift insolvencies were linked to "excessively growth-oriented strategies." A study of the so-called "Texas 40" (forty of the worst thrift failures in Texas) found that on average these institutions had grown 300 percent between 1982 and 1986 – three times the rate of other thrifts in Texas and over five times the general industry average (U.S. Congress. House 1989a: 576–95). The

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Federal Home Loan Bank Board did an analysis of California thrifts and found a similar growth pattern among insolvent institutions (ibid.: 524–72). Some of the costliest failures occurred in institutions that had grown by as much as 1000 percent in a single year (Barth 1991: 66). Among regulators, such rapidly growing thrifts in the 1980s came to be called "high fliers" (personal interviews).

The asset size of the high fliers is astounding. In the first quarter of 1984, 724 thrifts grew at an annual rate of 25 percent or more and 336 grew more than 50 percent a year. The fastest growers reported the highest profits, the highest net worth and the most nontraditional assets. By the second quarter of 1984, the most deregulated states – California and Texas – had respectively seventy-four and sixty-two thrifts growing at 50 percent annually, totaling over $75 billion in assets (Strunk & Case 1988: 132–34).

The combination of explosive growth and ADC lending produced extraordinary accounting profits, and catastrophic failures. The former chief economist at the Federal Home Loan Bank Board, Eric Hemel, points out, "Of the twenty-five thrifts showing the largest accounting profits in 1984, a majority were bankrupt by 1987" (Nash 1988: sec. 3, 14). An ADC loan is typically made to a real estate developer to buy land, develop it (e.g., grading it and putting in roads and sewers) and construct a building. These ADC loans were among the riskiest investments that financial institutions could make. In economic substance, these ADC loans were equity risk investments, e.g., they would only be repaid if the underlying investment succeeded. Because ADC lending created self-funded fees and interest that could be (with the aid of an accommodating accountant) claimed as accounting income, a thrift that grew rapidly by making large ADC loans was guaranteed to report that it was one of the most profitable financial institutions in America.

By the time Texas thrifts began to concentrate heavily on ADC lending for commercial development, commercial real estate already had surging vacancy rates. By September 1983, the office vacancy rate was 28 percent in Dallas and 35 percent in Houston; despite this glut of office space, Texas thrifts continued to pour money into commercial development, guaranteeing failure (NCFIRRE 1993b; Akerlof & Romer 1993).

These high fliers also failed to diversify their portfolio. Of the twenty-six failures studied by the GAO, twenty-three made "excessive loans to one borrower," or "LTOB" violations (U.S. GAO 1989a: 15). James Barth, professor of finance and a gambling-for-resurrection proponent, found LTOB violations in sixty-nine of 129 thrift failures he reviewed, and in thirty-one of the forty-two Texas failures (U.S. Congress. House 1990a: 610). These LTOB violations are of unusual significance in the thrift context because the LTOB limit was generally *100 percent of capital.* Moreover, virtually all of the largest failures in Texas invested heavily in ADC lending, shunning the diversification principle which would have minimized overall investment risk (U.S. GAO 1989a; NCFIRRE 1993a: 54).

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C. CONTROLS AND UNDERWRITING

There is wide consensus among experts on all sides of the fraud debate that thrifts that failed were consistently lax in their underwriting and controls (White 1991: 41, 75; U.S. Congress. House 1990a: 610; Lowy 1991: 74–76, 137–39; U.S. Congress. House 1989a). The Federal Home Loan Bank Board's review of S&L failures in 1988 found bad underwriting in 125 of the 147 cases for which it had adequate information. In Texas, the pattern was even worse, with bad underwriting evidenced at forty-five of forty-nine institutions (U.S. Congress. House 1990a: 610). The GAO reported that in the most costly failures it examined, all twenty-six had engaged in "inaccurate recordkeeping or inadequate controls," and twenty-four of the twenty-six routinely conducted "inadequate credit analysis" or "inadequate appraisals."

Nor were managers of insolvent thrifts responsive to regulators' concerns. The GAO found a persistent pattern of resistance to supervisory action. Of the twenty-six thrifts studied by the GAO, one-half of the twenty-two that signed administrative agreements with thrift regulators to alter their unsafe practices subsequently violated those agreements; others circumvented the agreements through subterfuge or technical loopholes (U.S. GAO 1989a: 73). By 1986, thrift lobbyists, led by the most insolvent Texas thrifts, were leading the campaign to neutralize thrift regulatory powers and end what the Texas Savings and Loan League referred to as the regulators' "antagonism" towards the industry (U.S. Congress. House 1990a: 185).

D. PATTERN OF SUCCESS OR FAILURE

Every thrift that grew extremely rapidly and invested in high-risk assets in the mid-1980s failed – catastrophically. As a staff report for the NCFIRRE reveals, every thrift that invested more than 10 percent of its assets in high-risk, direct investments by 1983 collapsed, piling up billions of dollars of losses (NCFIRRE 1993c: 13).

V. EVALUATING THE HYPOTHESES

A. TYPES OF INSTITUTIONS

The excessive risk taking and fraud hypotheses both predicted that the worst thrift failures would be disproportionately at stock institutions in the most deregulated states. Both predictions are supported, while the incompetence hypothesis' prediction of greater losses at mutuals is refuted.

The risk taking hypothesis' prediction that thrifts that were deeply insolvent in the early 1980s would constitute the most costly failures by the end of the decade is also refuted. The worst failures of the mid to late-1980s

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occurred at thrifts that on average were *less* insolvent than their peers in the early 1980s (Benston & Carhill 1992: 27–28). And, the worst losses were in Texas and California, where thrifts fared much better in the interest-rate crisis of the early 1980s than did thrifts in other states, particularly those in the Northeast where very few catastrophic thrift failures occurred (NCFIRRE 1993b: 16–17).

In addition, the disproportionate failure rate of thrifts acquired in the early 1980s by real estate developers and others outside the industry does not follow from the excessive risk taking hypothesis, but does follow directly from the fraud hypothesis. It was generally cheaper to buy an existing thrift that was insolvent on a market value basis than to start one up *de novo*, which usually required $2 to 3 million in capital. Small stock asssociations could be purchased after the interest rate crisis of the late 1970s for $1 to 2 million (Lowy 1991: 88), with the acquirer sometimes contributing grossly overvalued real estate in lieu of cash, as "capital." Regulators usually required appraisals for such contributions; however, with the help of a cooperative appraiser, an acquirer could claim that a $5 million property was worth $25 million, then exchange the real estate for $15 million in cash from the newly acquired S&L, and "contribute" $10 million in capital to the thrift. Other acquirers received large loans from the thrifts they wished to acquire and used a portion of the funds to buy the thrift with its own money. The opportunity to purchase an insolvent thrift for nothing, or even make an instant profit on such a purchase, and use it to generate guaranteed accounting profits, must have been a powerful incentive to those intent on fraud.

B. NATURE OF INVESTMENTS

All three hypotheses predict that the worst losses would occur in thrifts investing in high-risk assets. However, only the fraud model would predict the extent of concentration of risky assets in a handful of investment categories. As we have seen, a rational thrift manager gambling for resurrection would diversify at least minimally, and even inexperienced managers would quickly learn this basic principle of finance theory.

The concentration in ADC lending in Texas makes even less sense from the point of view of a manager not intent on fraud. Indeed, continued ADC lending in the face of a record glut of commercial real estate in Texas and virtually certain loan defaults, was profoundly irrational for a thrift gambling for resurrection (even for the most fervent "plungers," for whom in the 1980s there was a wide range of high-risk investments offering potentially exceptional profits); it was far-fetched for even the most inexperienced managers. The concentration of ADC loans among Texas thrifts can in fact *only* be explained by the fraud model, as a brief discussion of such lending makes clear.

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ADC lending is inherently one of the riskiest forms of investment by financial intermediaries, combining construction risks (related to unforeseen climate and weather problems, as well as engineering, design, and planning-related glitches); market risks (related to the viability and profitability of the project); and fraud risks (associated with borrower integrity). These risk factors were compounded by the mechanics of most ADC loans in Texas and California after deregulation. No cash down payment was required, 100 percent loan-to-value ("LTV") ratio was common, points and fees were self-funded through the loan (as were "soft costs" such as architects' and lawyers' fees), and the loan generally included an "interest reserve" from which interest payments for two years were drawn. There was no meaningful guarantee of repayment by the borrower, for example, no personal guarantee by a creditworthy builder, and developers frequently received an up-front fee funded by the thrift. The projects were usually "spec" projects, meaning that they were not preleased. As Lowy (1991: 131) points out, this emphasis on speculative projects was a radical departure from previous practice. In Dallas, Texas, almost all new commercial space construction was preleased in the early 1980s, but by 1984 two-thirds of such construction was speculative (ibid.).

Such ADC loans are exceptionally risky, but they should have been unattractive even to risk-loving "plungers" because they effectively constitute "sucker's bets." First, the context within which ADC loans were made ensured adverse selection of borrowers. Thrifts started the ADC lending process with two strikes against them: banks had been making commercial ADC loans for many years and continued to have good lending relationships with the best developers. Furthermore, by the time deregulated thrifts began ADC lending, the nation had already developed very high commercial real estate vacancy rates. By charging high interest rates and fees, and taking a high percentage of future profits, thrifts attracted only the worst borrowers and developers – those who had such limited access to other lenders and such poor hopes of project profitability that committing a substantial portion of future "profits" to the thrift imposed no real cost.

Second, the structure of these ADC loans created moral hazard in the borrower. With a 100 percent LTV, any ADC project hangs on the thinnest of threads. If anything goes wrong, even slightly, the project is doomed. Given the poor quality of the borrowers and developers likely to be involved and the ever-deepening glut of commercial real estate, it was highly probable that large numbers of ADC projects would go badly wrong. Further, since developers had no equity in these ADC projects, and no personal guarantees of repayment, they effectively had a green light to walk away from troubled projects and convert loan funds to personal use, letting the thrift foreclose on the loans and suffer the losses.

These ADC loans were thus a very bad gamble for well-intentioned thrift operators, but they were ideally suited to fraud. Specifically, they generated unprecedented *accounting* income, providing huge salaries, bonuses, and

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dividends for managers and stockholders through self-funded points, fees, and interest payments. In addition, of course, they provided the borrowers – who were often "straw borrowers" in cooperative "daisy chains" with insiders – with large pools of cash (Lowy 1991).

ADC lending was also an ideal vehicle for avoiding loss recognition. Since these speculative ventures had no readily ascertainable market value, insiders (with the aid of appraisers and accountants) could assure regulators that their value was adequate to repay the loan should the borrower default. Further, the difficulty of ascertaining market value facilitated the "rolling over" or refinancing of loans, which high fliers frequently did to confound regulators. Networks of thrifts refinanced each other's bad loans to keep them current and to book new income, leading to the insider joke, "A rolling loan gathers no loss." Similarly, the sale of a bad ADC loan to a straw buyer (referred to in the industry as "cash for trash") could remove it from the books if necessary to enhance the institution's picture of health and postpone closure. Indeed, such "sales" succeeded in turning a real loss into an accounting gain. In this context, adverse selection of ADC borrowers was rational for thrifts engaged in fraud: such borrowers would readily agree to the high interest rates and fees that maximized phony accounting profits for the thrifts, and were likely to agree to serve as straw borrowers when necessary.

As James Pierce (1994), director of the NCFIRRE, explained to his fellow economists:

> Accounting abuses . . . provided the ultimate perverse incentive: it paid to seek out bad loans because only those [borrowers] who had no intention of repaying would be willing to offer the high loan fees and interest rates required for the best looting. It was rational for [thrift] operators to drive their institutions ever deeper into insolvency as they looted them.

A thrift that grew rapidly by ADC lending was thus *guaranteed* to report record income. It was a mathematical certainty. The more cash the thrift sent out the door, the more "income" it reported. It was the ideal paradox for the thrift manager intent on fraud – an extraordinarily risky asset would produce an extraordinarily risk free *accounting* profit for several years, providing ample justification for generous bonuses and dividends. Growth, however, was not simply a means to maximize the fraudulent insiders' profits; rather, it was a necessity to postpone the collapse of the underlying Ponzi scheme. The only way for an ADC Ponzi to fund interest on deposits and deposit withdrawals was to grow rapidly and pay the old depositors with the funds that new depositors provided, with federal insurance providing the ability to attract deposits in the necessary volume. It was for this reason that the most catastrophic thrift failures (e.g., Empire, Vernon, Lincoln, CenTrust) grew the fastest and consistently reported the highest profits throughout the mid-1980s.

Because explosive growth, funded through high-interest brokered deposits that were invested in huge ADC loans, provided the accounting income

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from which to draw generous executive salaries, bonuses and dividends, thrift owners and managers intent on fraud encouraged growth at all costs. While pouring money into a glutted commercial real estate market through ADC lending makes no sense from the standpoint of a well-intentioned profit maximizer, it is perversely rational for those engaged in fraud. Growth is the engine of accounting profits that feed executive incomes, as well as line the pockets of associated borrowers. Following this logic, project viability is of no concern; what is important is growth and the fee income it generates. Tyrell Barker, owner and operator of State Savings and Loan in Texas, told developers in Dallas in the early 1980s, "You bring the dirt, I bring the money . . . ." (Pizzo, Ricker & Muolo 1989: 191). When one Barker-financed developer was asked how he determined what property to buy, he replied, "Wherever my dog lifts his leg I buy that rock and all the acreage around it" (ibid.). So common were such arrangements that they came to be called "cash-for-dirt" loans.

C. CONTROLS AND UNDERWRITING

The prediction of the risk taking hypothesis that thrifts would seek to employ good underwriting and internal controls is contrary to the facts at the worst thrift failures. The greater the intrinsic credit risk, the greater the economic rewards for proper underwriting. The fact that underwriting and control deficiencies were so common, long-running, and resistant to regulatory criticism, even at those thrifts where high-risk investments were the norm, is sharply at odds with the risk taking model.

Nor can these deficiencies be explained away as a product of incompetence. We might expect novice managers to commit errors in the more difficult aspects of underwriting; however, the evidence suggests that at the worst failures, managers were conspicuously indifferent to underwriting, getting even the most basic aspects wrong and exhibiting no improvement over time (U.S. GAO 1989a; NCFIRRE 1993b, 1993c). Thus, it was not unusual for the fastest growing Texas thrifts in the mid-1980s to extend ADC loans *before* a loan application had been completed and signed; appraisals and credit checks were often conducted *after* the loan had been disbursed (Pizzo, Fricker & Muolo 1989; personal interviews). Furthermore, contrary to the "well-intentioned, but incompetent manager" hypothesis, these managers were uninterested in honing their skills through cooperation with regulators.

Gross inadequacies in underwriting and internal controls, in conjunction with resistance to regulatory efforts to improve these deficiencies, are consistent only with the fraud model. Indeed, thrift managers in the worst failures were aggressive in their efforts to deceive and otherwise neutralize regulators, activities that themselves constitute fraud. In the twenty-six thrifts studied by the GAO (1989a: 51, 40), *all* had engaged in covering up losses or disguising suspicious business practices. In addition to loan swap-

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ping and other techniques to inflate their picture of financial health, some thrift managers simply doctored their records. At one thrift studied by the GAO (ibid.: 41), three irreconcilable sets of books were kept – two on different computer systems and one manually. Noting the prevalence of such deception, the president of one thrift testified to Congress that:

> [i]nstead of attempting to remedy the problems which were so apparent, they [industry operators] spent all of their efforts in proposing intricate schemes which . . . would appear to aid in maintaining the equity at a proper level. (U.S. Congress. House 1987: 546)

Some might argue that risk-lovers or plungers might on occasion "bet the farm," but even they would take some time to calculate the odds and choose the best investment ("underwriting"). It is extremely unlikely that a large portion of any industry would be such plungers that they would always bet the farm; it is even less likely that they would consistently do so with no concern for the odds of the bet. The only scenario in which this makes sense is one in which "betting the farm" is a vehicle for personal – rather than institutional – enrichment. In this scenario, "betting the farm" is a misnomer, since the fraudulent owner has in fact chosen a "sure thing," not placed a bet.

D. PATTERN OF SUCCESS OR FAILURE

The catastrophic failure of *every* high flier and the failure of *every* thrift with greater than 10 percent of its assets in high-risk direct investments by 1983, is inexplicable under the excessive risk taking model. A high-risk portfolio should have produced scores of success stories among these rapidly growing thrifts during the strong economic climate of the mid-1980s. Even among plungers who failed to diversify, there should have been a few big winners. Instead, there were no success stories. In this regard, the failure of California high fliers investing primarily in California real estate – a market that was soaring at the time they failed – is particularly instructive. Neither can the incompetence model explain this consistent failure, unless we are willing to stretch credibility by arguing that somehow *all* managers of fast-growing thrifts with risky assets were grossly incompetent, and that that incompetence in every case led to catastrophic failure.

In contrast, universal failure is precisely what the fraud model would predict, since looting, Ponzi schemes, and other such insider frauds are invariably fatal. The catastrophic nature of these failures derives from the combination of such insider fraud, with the perverse incentives to make bad loans and to prevent internal controls that would have minimized external fraud. Thus, holding substantial direct investments by the mid-1980s was consistently fatal not because of the *intrinsic* risks of direct investments (which could have been offset by good underwriting, diversification, etc.), but because they were such superb fraud vehicles.

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There is little disagreement over the facts presented here. Experts, government officials, and academics from both the minimal fraud and the material fraud schools agree on the observed reality within the worst thrift failures. Disagreement arises over the issue of intent and the degree of deliberate fraud involved. As we have seen, the observed facts are at odds with both the "excessive risk taking" and the "managerial incompetence" hypotheses. They are, however, consistent with the hypothesis that there was widespread fraud at the worst thrift failures in the mid- to late-1980s. Indeed, if we assume that thrift managers are rational economic actors, deliberate insider abuse is the only viable explanation for the behavior of insiders at the worst failures.

This is not to say that there were no, or only a few, failures not attributable to fraud, or that there is no overlap between these categories. Plainly, some thrift executives convicted of fraud were also incompetent. A number of thrifts no doubt did gamble for resurrection; some of them were probably also run by incompetents. However, these cases did not produce the worst failures and the catastrophic losses associated with the thrift debacle. Nor, as we have seen, can they account for the pattern of thrift failures that together comprise this financial disaster. Table 1 summarizes our empirical evaluation of the three models.

Table 1.

	Model Predictions		
Observed Facts at Worst Thrift Failures	Risk taking	Incompetence	Fraud
Concentrated in deregulated states	yes	yes	yes
Tightly held stock assets	yes	no	yes
"Zombie" institutions	yes	na	yes
Change of ownership	no	yes	yes
Explosive growth	yes	na	yes
Concentration of risky assets	yes	yes	yes
Little diversification	no	yes	yes
Deficient controls and underwriting	no	yes/no	yes
No responsiveness to regulators	no	no	yes

VI. CONCLUSION

It is a commonplace to note the complexity of white-collar crime and the difficulties of distinguishing it from ordinary business transactions (Katz 1979; Levi 1981; Tillman & Pontell 1992). Addressing cases in which financial failure is involved, Michael Levi (1984: 322) points out:

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> Since the aim of the more sophisticated fraudster is to manufacture the appearance of an ordinary business loss or at worst, of the "slippery slope" rather than deliberate fraud . . . the actual allocation of any given business "failure" to any of these categories is highly problematic.

It was this difficulty that led Sutherland to suspect that white-collar crime was more pervasive than official statistics indicated, and to set about uncovering corporate illegality. This same difficulty led Tappan to conclude that the search for a "true" level of crime, beyond the certainties of official definitions, was misguided and resulted in subjectivism and idle speculation. Subsequent scholars (Burgess 1950; Caldwell 1958; Orland 1980) followed Tappan in insisting that criminologists should focus on conduct that the criminal justice system has determined to be criminal, since actual convictions are the closest we can get to a definitive indication of criminal activity.

The disagreement over the extent of fraud in the thrift industry in many ways echoes this methodological and epistemological debate. Members of the material fraud school, comprised mostly of thrift regulators, GAO researchers, FBI investigators, and others inside the thrift industry cleanup, argue that fraud was directly or indirectly responsible for many of the worst thrift insolvencies and contributed substantially to the cost of the bail out. Relying on individual case studies, an accumulation of anecdotes from the investigatory front lines, and regional studies, these experts maintain that convicted offenses account for only a small fraction of the totality of frauds contributing to the thrift debacle. Much fraud, they argue, remains shielded behind the complex business transactions within which they were embedded. Moreover, they point out, the volume of thrift crime overwhelmed prosecutors, requiring that some meritorious prosecutions be declined. Even when prosecutions are brought, prosecutors typically charge only the most easily prosecuted, often low-cost, crimes rather than the fundamental, highly complex schemes underlying the high fliers' operations (personal interviews).

In contrast to this view is the minimal fraud argument of many economists and thrift consultants. While they are unlikely to have read Tappan, like him minimal fraud proponents argue that the best gauge of criminal behavior is criminal convictions. Noting the small number of thrift offenders who have been convicted (relative to the scope of the disaster), they maintain that most of the losses were the result of (1) excessive risk taking that was rational economic behavior within the context of "moral hazard"; and (2) mismanagement or poor business judgment. Despite their disdain for the anecdotal approach of material fraud proponents, these experts provide little empirical evidence for their assertion that fraud played a minor role in the collapse of the thrift industry, other than the relatively small number of convicted offenders.

In this paper we evaluated the relative validity of the material fraud and minimal fraud hypotheses by comparing predictions derived from these

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hypotheses with the observed reality of thrift behavior. There are substantial data available on the nature of this reality. As we have seen, these data confirm the material fraud school's assertion that deliberate insider abuse permeated the worst thrift failures and contributed significantly to their collapse. Indeed, we demonstrate that the behavior that economists from the minimal fraud school insist was merely risky business makes no sense from the point of view of a rational economic actor *unless that actor is engaged in fraud.* In other words, following the economists' own model of humans as rational profit maximizers, fraud is the only viable explanation for the behavior of these high fliers and the consistent pattern of thrift failure.

Resolving the debate over the extent of fraud in the savings and loan crisis is important, for it provides the foundation for more detailed research into the relative role of individualistic versus structural or environmental factors in thrift crime. Future research might extend the logic employed here to differentiate fraudulent from non-fraudulent institutions in the interest of isolating specific variables as central in the etiology of these white-collar crimes.

More generally, this study demonstrates the utility of deductive reasoning as a way to estimate the parameters of white-collar crime, thereby providing an escape from the epistemological dilemma first posed by Tappan. While Tappan clearly exaggerated the degree of "subjectivism" used by white-collar crime researchers, and conflated the issue of cultural definitions of crime with that of selective processing, he nonetheless was on to something: how *do* we as white-collar crime scholars locate the population we intend to study, especially given the proclivity of this population to disguise its behavior as legitimate business transactions? This analysis suggests the powerful potential of deductive reasoning in this endeavor. While the nature of the material admittedly does not permit a strict use of the hypothetical-deductive method, nonetheless, as we have seen, this approach offers a useful heuristic possibility for organizing complex data and for estimating the boundaries of white-collar crime.

Finally, the paper contributes to a number of practical concerns. Perhaps the most difficult task for prosecutors in savings and loan cases is to distinguish between deliberate fraud and ordinary business transactions gone bad – a distinction that often rests entirely on the subjective question of intent. The prosecutors' task is formidable, particularly as thrift operators have often painstakingly constructed their offenses and the intricate deals of which they are a part, so as to paper over their misconduct. Facing a jury with little financial expertise complicates further the prosecutor's job of persuasively unraveling these complex transactions to reveal fraudulent intent. It is hoped that the deductive methodology employed here might contribute to this prosecutorial effort (and to defense efforts where the reasoning is inconsistent with a finding of fraud). In other words, in complex financial transaction cases in which the evidence is voluminous but

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smoking guns are rare, it may be possible to tease out deliberate wrongdoing deductively as we have done here.

At least as important, confirming the significant role of fraud in the thrift crisis has implications for future policymaking. Confronted with evidence of an epidemic of fraud, we need to look beyond individual characteristics as causal factors, and examine the criminogenic environment that set the stage for this misconduct. Expanded thrift investment powers, federal deposit insurance, accounting abuses, and lax regulatory enforcement in the early 1980s, provided incentives and plentiful opportunities for crime with few risks attached. The scale and scope of the fraud that followed attests to the devastating impact of such structural forces, and the proclivity of a large minority of individuals to capitalize on those opportunities. As policymakers consider future reforms in other financial institutions such as the banking industry, insurance companies, pension funds, and credit unions, it is critical that they take seriously the thrift experience, making every effort to set in place structures that systematically impede rather than encourage fraud.

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NOTES

1. "Thrift" is a term that technically includes a broad range of savings institutions that have as their primary historical function the provision of home mortgage loans. We use the term here for reasons of brevity to refer to federally insured savings and loan institutions.
2. As part of the larger study from which the present work is drawn, open-ended interviews were conducted with close to one hundred thrift regulators, investigators, and policymakers over the course of a three-year period between 1990 and 1993. To ensure confidentiality, these interviews are referred to throughout this paper simply as "personal interviews."

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3. It is perhaps this dilemma that has influenced white-collar crime scholars to focus on individual case studies, rather than launching large-scale quantitative analyses of white-collar crime and its correlates. In the absence of large statistical data sets other than those provided by the criminal justice system, white-collar criminologists have generally turned instead to the in-depth study of particular offenses. Geis (1991) even suggests that recent attempts at quantitative analyses of white-collar crime have entailed serious "compromises" related to "the nature of the data [which] forced the researchers to jettison key elements of the definition of white-collar crime."
4. It is estimated by the NCFIRRE (1993: 44) that if S&Ls had simply been prevented from growing or taking on undue risk while waiting out a drop in interest rates, the original interest rate crisis might have been resolved for under $25 billion.
5. Stock association thrifts are owned by shareholders who are paid dividends for a thrift's profitable performance; "mutuals" are owned by depositors whose "dividends" are a fixed interest on deposits. In 1982, regulators dropped the requirement that all stock association thrifts have at least four hundred shareholders, with no one owning more than 25 percent of the stock.
6. Criminal referrals are formal notices of reasonable suspicion that a crime has been committed. These referrals are forwarded by the thrift regulatory agencies or, more commonly, by the institution itself. As the Justice Department is quick to point out, several referrals may involve the same incident, and some referrals do not involve criminal or even regulatory violations. Thus, the number of referrals is not necessarily an indication of the amount of actual criminal activity.
7. "Major" cases are defined by the Justice Department as those in which "a) the amount of fraud or loss was $100,000 or more, or b) the defendant was an officer, director, or owner [of the S&L] . . . , or c) the schemes involved multiple borrowers in the same institution, or d) involves [sic] other major factors" (U.S. Department of Justice, 1992a: 9).
8. It is also important to note that individual predispositions toward risk are not essential to this "excessive risk taking" model. That is, the gambling model does not assume that a large number of thrift owners were originally "risk lovers," nor that they came to enjoy risk subsequent to insolvency. The point is that "high-risk" investments posed no real risk of financial loss to owners of already insolvent thrifts. Thus, even a rational risk-*averse* owner of the typical insolvent thrift would gamble for resurrection under this model.
9. As gambling for resurrection proponents Benston and Kaufman (1986: 53) explain:

   > A primary activity of banks, and one for which they have a comparative advantage over many other organizations, is the assessment, monitoring, and resolution of credit risks. Such risks are kept within acceptable bounds by means of regularized routines for documentation, approval and follow-up of defaults.

10. It follows that thrifts that engaged in insider fraud, and therefore poor internal controls and inadequate underwriting, would be likely to suffer from external fraud as well.

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