U.S. Banking and Its Regulation in the Political Context

Sarkis Joseph Khoury

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Preface

Banking and other financial services were once relatively easy to understand. As recently as the 1970's, most consumers tended to divide the financial marketplace into two categories: banks that offered checking and savings accounts, made all types of loans, and gave a wide range of financial advice, and savings and loan associations that offered savings accounts and made home mortgages. Strict federal regulations made it unnecessary to shop around for the best interest rates on savings since each paid the rate allowed by the government. However, over the past few decades the nature of financial services has undergone a revolutionary transformation. Consumers are now faced with a bewildering array of financial choices. For example, savers often find it difficult to understand the multitude of terms and rates offered by the various institutions. Out-of-state offers for insurance policies, mortgage loans, and bank credit cards now flood the mail.

Although most people may by aware that the financial marketplace has changed significantly, few are really aware of the causes and effects of this transformation. Deregulation is an important part of the story, but changes in both technology and the economy have also contributed to the restructuring of the new financial services industry. Regulators and industry executives alike have struggled at times to keep up with the quickly changing markets. Critical questions that will determine the future structure of the industry are yet to be decided. Vast amounts of money have been staked in this large political battle between regulation and the marketplace.

This book begins as an examination of the American banking industry and its dire need for reform. Its specific genesis is the Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which was signed into law of August 9, 1989. FIRREA was perhaps the most sweeping piece of banking legislation enacted in over 50 years. Virtually all depository institutions, their regulators, and even consumers are affected in some way. It was enacted to bail out troubled thrift institutions and to provide a recovery pattern for the remaining institutions. The Act attempted to do this by reorganizing the structures and the standards of savings and loan institutions and increasing the regulatory and enforcement powers of the Federal Deposit Insurance Corporation (FDIC). It also created the Office of Thrift Supervision (OTS) which has additional supervisory and regulatory authority over federal and state savings and loan institutions.

The key dimension of this book is to show how this and other banking regulations came to pass despite intensive planning and lobbying by the Bush Administration for a legislation that was engineered to produce results diametrically opposed to FIRREA. We argue that the reason for this legislative perversion is the lobbying process and the corruption of politics by heavy financial contributions. In this respect, the book offers an insight into the nature of the regulatory platform on which financial institutions compete.

FIRREA has had a major impact on the future of savings and loan associations as well as other depository institutions. This work examines many of the potential effects of this "banking reform". After weighing the merits and justification for FIRREA, it became clear that it is also necessary to explore the arguments offered for and against the bill. Besides considering the positions advanced by the legislative actors themselves, it became imperative to study the legislative environment: the relevant interest groups, such as regulators and the industries affected by the legislation. In brief, an inquiry into the politics of regulation in America illustrates the fact that political and economic factors are very much intertwined. A classic study of business regulation suggests that the "determination of regulatory goals does not result inevitably from the logical analysis of certain economic facts, nor is it automatically deduced from a set of propositions concerning the nature of the political state and the proper boundaries of political action in a democratic society."[1]

Thus, regulatory decisions usually are as much political as they are technical. Political, in this sense, is to be concerned with the

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[1]Marver Bernstein, *Regulating Business by Independent Commission*, (Princeton: Princeton University Press, 1955), p. 258.

allocations of values and power in society. Value choices are made because important questions concerning regulation frequently involve differences of interests, benefits, or views, particularly those of affected interest groups. In a large democratic society such as the United States, frequently there is a lack of consensus on the values to be given primacy and there is almost always conflict over the allocation of those values. The conflict involves competing ideas the interest groups that all claim to represent various values. In a democratic society, policy struggles take the form of competing efforts in order to persuade those in a position of authority to make the allocations for society.[2] Especially when there is a lack of consensus, policy making is almost always an exercise of political conflict that consists of bargaining and the search for acceptable trade-offs among multiple objectives. Needless to say, these multiple objectives are frequently brought into the political arena by organized interest groups.

Regulatory standard setting is thus a political process. The struggle over banking reforms proves to be no exception. Our inquiry has discovered that the same political factors were also at work behind the adoption of "banking reform." The difficulty of this decision-making process is that the preconditions necessary for making decisions, on the merits of a particular bill or regulation, are rarely present in public affairs. This book focuses primarily on the legislative part of public policy making. Because of the looseness and fragmentation of the American system, political struggle permeates policy making at all levels and stages of the political process. The process is particularly permeable to organized pressures. This feature is exemplified in the banking legislative process.

The U.S. Constitution involves Congress deeply in the national policy-making process, although it shares authority with the other branches. Congress possesses the twin abilities of authorizing and funding public policies and thus it has a major role in both the shaping and the reform of public policy. So, what began as an inquiry into banking reform was expanded to include a look at the legislative process and its relationship to banking reform. The book uncovers the political reasons behind the obtained banking reform. The intriguing part is the lobbying process. Reform is usually the result of political pressure by the few and is not necessarily in congruence with the

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[2]David Easton, *The political System*, (New York: Knopf, 1953), p. 129.

interests of the many. Besides spending millions of dollars each on a wide variety of lobbying efforts, interest groups and their PACs donate many millions of dollars to various congressional campaigns. The intense lobbying and often massive campaign contributions work against badly needed reform. Having made this point, the book also argues for the need for campaign financing reform in general and briefly discusses some specific recommendations designed to make the legislative process more responsive to the public interest and less susceptible to interest group pressure.

Sarkis Joseph Khoury

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This book constitutes an important step in my search for effective policy making consistent with the public interest. My experience as a former candidate for the U. S. Congress exposed me to a side of politics that initially dampened my enthusiasm for public service; however, this project has restored a belief that the system can be changed through sound efforts at reform.

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Chapter 1

Overview and Introductory Analysis: The Politics of Banking

Introduction

The theory of finance has been consumed for nearly a century with resource allocation across time and between economic agents, and with how efficiently financial markets and financial institutions facilitate that allocation. Government regulation interferes with this process and is usually looked upon as an exogenous phenomenon. Elegant general or partial equilibrium models have been developed under static or dynamic conditions in order to arrive at security prices. Changes in the regulatory environment have been analyzed in terms of their impact on equilibrium prices, or on the adjustment and its speed in the transition from a disequilibrium to an equilibrium state. The *missing links in all of the theories are the following:*

1. Does the reality in the financial markets influence policy changes on the federal and state levels? Is the policy change holistic in its core or simply targeted to address a specific problem with minimum concern as to the effects (negative ones, especially) it may produce? For example, if inflation has a negative effect on security prices, should we control inflation solely for this purpose and should we be concerned with the effects this would have on employment, the budget deficit, etc.?

2. Are policy initiatives generated by the reality of the markets with the intent to achieve maximum efficiency or by the carefully structured arguments of lobbyists for special interest groups? The latter would move the market from one disequilibrium condition to another with one group benefiting at the expense of the rest of society. Effectively, the results are income redistribution that is skewed towards powerful interest groups with their power clearly a direct function of political contributions.

3. Does the Congress initiate legislation or does it simply operate in the domain of intellectual darkness and legislative sterility by simply rubber stamping the policy changes proposed by the presidency, the bureaucracy, its own professionals, or even the lobbyists? The evidence is plentiful that major legislation, such as the one that created the Resolution Trust Corporation (RTC), was voted upon with barely any of the members of Congress ever reading what they voted on.

Should the banking industry control the major policy initiatives affecting its own growth and profitability, and consequently influence its business and financial risk? If so, then lower risk premium would emerge on banks than on other industries in the marketplace. If banks, no matter what difficulties they get into (especially as a consequence of their own actions), can produce a legislation to bail themselves out, then the market may be inefficiently pricing their securities. For example, if banks can persuade the American government to increase funding for the International Monetary Fund (IMF) so that it in turn can bail out debtor countries that owe money to these banks, then the banks have successfully reduced or eliminated the risk of their sovereign portfolio. If these banks find ways to create agencies, such as the RTC, change their capital requirements, and receive only minimum sentences for thefts and indiscretions, then the risk premium the market assigns to them is exaggerated and inefficient—unless the above is fully endogenized in any bank security pricing model. There is little evidence to suggest that the value of the safety net constructed by bankers is discounted in bank securities prices.

Therefore, our study focuses on the source of policy initiatives and the attending legislative process, instead of just their consequences. It is an extensive, but focused look at how politics and economics mix; and how the political process is frequently stunted or completely hijacked by special interest groups, who, in the process, produce a playing field for banks that is completely diagonal to the desired one, or is inconsistent with the long term interest of the public. Swarms of lobbyists, seeking to protect and advance their own narrow interests, descend upon Congress and make it difficult for legislators to discover the "real majority" and to legislate in the public interest. Much of interest group activity involves acquiring expert information about policy and reporting this information to legislators. As is illustrated in more depth later in this work, special interests employ policy experts, such as economists and scientists, for just this purpose. In addition to conducting their own studies, they testify before congressional committees. They also retain expensive and well-known Washington law firms to represent them in judiciary proceedings before courts and federal agencies. They make significant campaign contributions and engage in voter mobilization in order to support their friends in the legislator.[1] Finally, interest groups meet one-on-one with legislators and their staffs in Washington, and undertake grassroots campaigns as a way of demonstrating the political costs and benefits of various policy alternatives.

Preliminary Analysis

Banking laws and regulations in the United States have wide ranging effects on the economy and the standards of living of every American. The financing of America is critical to its development as an industrial, military, and political force in the world. The financing packages offered in certain international transactions influence our economy and the balance of our international accounts. Those offered domestically influence the nature and the level of the economic activity. The financing of transactions is also an important component of marketing a product. Witness the financing strategy of Airbus, and its successful implementation, in the aviation industry on a worldwide scale in its attempt to wrestle away market share from Boeing.

Although government regulation is frequently cited as an explanation for many of our economic setbacks, we shall focus instead on precisely how the political forces, often conflicting and numerous, and the institutional structures contribute to the creation of a regulatory structure for a financial system; a system which is losing ground internationally and is affecting, occasionally adversely, the level of business activity in the United States—if not in the world. It is also essential to recognize that government regulation is not necessarily the product of a politically neutral process of determining

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[1]See Jeffrey Birnbaum, *The Lobbyists: How Influence Peddlers Get Their Way in Washington*, (New York: Times Books, 1992).

the public interest but it is often the direct result of the struggles between special interest groups. In fact, interest groups expend a significant amount of political capital and economic resources in order to sway regulation in their particular direction.

This study examines in detail the political circumstances which surrounded major changes in banking laws and regulations in the 1980s. It discusses the process in which pressure groups, their lobbyists, and the existing governmental structures worked together, or competed against each other, in order to produce changes, regardless of whether those changes were consistent with the public's interest and preference. In brief, we will attempt to show how the political process works to force discussion, analysis, and, ultimately, policy upon the Congress of the United States. As a consequence, the rules for banks are set by individuals and interests not elected by the people. This raises serious questions concerning any meaningful conception of popular sovereignty and public accountability. It seems, in fact, that the public actually has very little direct input into the process.

One consequence of this study, for example, is the laying of an intellectual foundation for understanding whether the FDIC continues to exist as a stabilizing tool for the banking system or as a mechanism for perpetuating an entrenched and unyielding bureaucracy that is essentially a fourth branch of government. The Bureaucracy frequently finds ways to enlarge itself, such as through the creation of entities like The Resolution Trust Corporation.[2] Administrative agencies provide channels of access through which segments of the public can advance or protect their interests. From this perspective

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[2]See Kenneth Meier, *Politics and the Bureaucracy*, (Monterey: Brooks/Cole, 1987) and Francis Rourke, Bureaucracy, *Politics, and Public Policy*, (Boston: Little, Brown, 1976), for excellent discussions of the importance of the bureaucracy in the political, as well as in the administrative process, respectively, in the United States. Both illustrate the necessity of seeing the bureaucracy as a fourth branch of government possessing the ability to both check and be checked by the other three branches. They also argue that an administrative agency's power depends upon its ability to command the support of fervent and substantial clientele groups. In short, interest group activity is essential in understand the administrative law and regulation process.

there is no disputing the fact that a great deal of administrative influence can also be explained within the framework of group theory.[3] Also, we would be able to determine whether the unique nature of banking institutions affected by the banking legislative process is reflected in bank securities prices.

The most important question addressed by our study, however, deals with whether banks control the legislative process or whether the legislative process controls banks. Only the latter would be consistent with a democratic and capitalistic system.

A major portion of this analysis deals with precisely how the political process, the built in institutional biases, and defensive mechanisms among various special interest groups work. This working relationship produces what is currently the American banking structure with its mechanism for dealing with its anomalies and regulatory failures. The study seeks specifically to examine the likelihood of an asymmetry between the public and the private interest and the extent to which government bureaucracy may act to preserve itself and its interests rather than the interest of the public.

It must be noted, however, that the lobbying of government and public officials is not necessarily inherently bad or undesirable. Since government in America, at all levels, regulate virtually all aspects of our lives and since it collectively accounts for approximately 40 percent of our Gross Domestic Product, it is essential that private input be weighed in the public policy-making process. After all, lobbying does fall under the purview of the 1st Amendment right to petition the government for redress of grievances. Americans have the constitutional right to associate with others who share their beliefs and positions. They have the right to organize themselves in order to act upon their beliefs. Today, government activity ranges from the purchasing of everything from staples to financial services to nuclear submarines, and the regulating of everything from workers safety and compensation to public education. Hence, guaranteeing access and

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[3]For a more extended discussion, see Randell Ripley and Grace Franklin, *Policy Implementation and Bureaucracy*, (Chicago: The Dorsey Press, 1986), Michael Reagan, *Regulation: The Politics of Policy*, (Boston: Little, Brown, 1987), and Francis Rourke, *Bureaucratic Power in National Policy Making*, (Boston: Little, Brown, 1986).

favorable treatment is not inconsistent with the free market system. It is necessary to insure however, that the access and the influence over policy is truly open and broad-based in order to prevent it from becoming exclusionary and sinister.

It has been argued that the influence of special interest groups goes well beyond reasonable access.[4] Political parties and corporations corrupt the political process and violate the spirit, if not the letter, of election laws. Corporate and special interests have channeled tremendous amounts of money into the policy-making process. They understand that the political lever among politicians is frequently money. Politicians often use this money against one another as well. For example, one of the best ways for a political party to encourage discipline is to make it clear that the President is more likely to raise funds for those particular members of Congress for reelection who support his policies. It has been observed that money is the "mother's milk" of politics. This fact has led to the institutionalization of fund raisers, direct mail, and cocktail receptions. Even the competition for assignment on the desirable Congressional committees (from a financial consideration sense) reflects the drive for financial contributions. Members of Congress want to be on Standing Committees that enable them to satisfy and service their constituents, particularly the ones organized into active and well financed interest groups.

The 1996 election saw $2 billion spent to elect the Congress of the United States. Fully ninety five percent of the incumbents running for reelection prevailed. They typically overwhelmed their opponents with funds raised primarily from special interest groups. This election was noted for the extravagant and apparently illegal use, in some cases, of "soft money" whose full impact and repercussions, legal and otherwise, have yet to be felt. There was the Indonesian Connection, the Indian Connection, and the money from Buddhist monks. The Republican Party had raised $278 million in hard money in the 1996 election cycle; the Democratic Party raised $146 million. The soft

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[4]See Elizabeth Drew , *Politics and Money: The New Road to Corruption*, (New York: Macmillan Publishing Co., 1983), where she asserts that political parties and corporations corrupt the political process with the pervasive increase money.