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The Keating Five Legacy



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Submitted by OurFuture.org Staff

April 9th, 2008

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Twenty-one years ago today five U.S. senators met with federal savings and loan regulators at the request of Charles Keating, who controlled Lincoln Savings and Loan. They became known as the "Keating Five"—Alan Cranston, D-Calif., Dennis DeConcini, D-Ariz., John Glenn, D-Ohio, John McCain, R-Ariz., and Donald Riegle, D-Mich. The Keating Five meeting was the event that transformed the S&L debacle from a story buried in the business section to one of the worst financial and political scandals in U.S. history (though the current financial crises have proven even worse).

The Keating Five, including McCain, were perfectly situated to take action to protect their constituents. They could have held oversight hearings. They could have warned the widows. "All that is necessary for the triumph of evil is that good men do nothing," an anonymous commenter one said (in a statement generally, but inaccurately, attributed to Edmund Burke). These men did nothing.

Lincoln was (and remains) the most expensive S&L failure of an insured U.S. depository, costing the taxpayers \$3.4 billion. Keating recruited the senators because the regulators were about to remove his control over Lincoln. The regulators had discovered that Lincoln had large losses and was engaged in widespread fraud and forgeries designed to hide its violation of the "direct investment" rule. That violation was the largest in history — over \$600 million. S&Ls that had large amounts of direct investment always failed. Direct investments were fatal not because of their intrinsic risk, but because they were superb aids to accounting fraud, the "weapon of choice" of financial firms.

When Keating launched a jihad against the proposed direct investment rule in 1984, he used politicians as his most important ally. He began in the House of Representatives. Within a few weeks, he was able to get a majority of members to co-sponsor a resolution intended to kill the direct investment rule. The supporters included John McCain (then a congressman), Jim Wright, D-Texas, (soon to be the Speaker of the House), and Newt Gingrich, R-Ga., (soon to be Wright's nemesis and a strong critic of his aid to fraudulent S&L owners). McCain was, and remains, a strident opponent of financial regulation. Federal Home Loan Bank Board chairman Edwin Gray, convinced that direct investments posed a critical threat to the taxpayers, went ahead with the regulation.

Second, Keating tried to get President Reagan to fire Gray. Keating's lobbyist, "Mickey" Gardner, reported that they found significant support within the administration for this effort—particularly in the office of Vice President Bush (who chaired the administration's financial deregulation task force). The (Republican!) lobbyist reported in disgust that he couldn't get Gray fired because "like so many before him in this Administration, [Gray] would

have to be criminally liable or worse before they would be removed."

Third, Keating followed Gardner's advice to stage a hostile takeover of the regulator in 1986. He had already used large political contributions and the lobbying of Alan Greenspan to recruit the "Keating Five." He now used several of the congressmen, principally McCain (the only Republican among the Keating Five), to help convince the Reagan administration to appoint two of his cronies to the Bank Board (which would have given Keating majority control of the agency).

Keating needed the senators' help to overcome rival candidates and internal opposition to the nominations. Phil Gramm, a more senior Republican senator on the banking committee, pushed the nomination of Durward Curlee, a Texas lobbyist representing the most notorious S&L frauds in Texas and, after Keating, the strongest opponent of S&L regulation. Keating was a major contributor to President Reagan, but he had never held elected office. His ability to convince the Reagan administration to reject Gramm's proposed nominee and agree to appoint both of Keating's proposed nominees was an astonishing demonstration of political power.

Keating also had to overcome serious internal opposition within the Reagan administration. The administration attempt to nominate Keating as U.S. ambassador to the Bahamas in the early 1980s had to be abandoned in embarrassment when it was revealed that Keating had signed a Securities and Exchange Commission consent decree to settle allegations that he had defrauded a financial institution. The White House personnel director, Robert Tuttle, was in charge of vetting Keating's proposed nominees. He called Republican contacts in Arizona (where Keating lived) and learned that Keating's had a reputation "for buying politicians." Tuttle recommended against the Keating appointments.

Keating's flaws were immediately obvious. In addition to his SEC problems, he was arrogant, domineering, rude, nasty, and a virulent bigot. Senator Garn (R. UT) refused to meet with him again after their first meeting. Treasury Undersecretary George Gould, instructed the Treasury guards to bar Keating from entry after their first meeting. Nevertheless, President Reagan rejected Tuttle's recommendation and tried to appoint both of Keating's choices. Had he succeeded, the cost of the debacle would have grown tenfold and the political scandal would have dwarfed Teapot Dome. Fortunately, Senator Dole blocked the nomination of one of Keating's choices.

President Reagan did make Lee Henkel a recess appointment in 1986. Henkel became Keating's "mole" on the Bank Board. His first substantive act was to propose an amendment to the direct investment rule (secretly drafted by Keating's lawyers) that would have immunized Lincoln's massive violation of the rule. (The amendment was cleverly drafted in a manner that did not mention Lincoln, but fit it like a glove.) Unfortunately for Keating and Henkel, I spotted the effort and blew the whistle. Henkel was severely criticized by the media and resigned in a deal with a Justice Department (in return, they dropped their investigation). (Years later, the Bank Board's successor agency "removed and prohibited" Henkel from the industry for his misconduct.) The Keating Five knew that Henkel had sought to amend the rule to immunize Lincoln, and they knew that he had resigned in disgrace. Appropriately, the resignation became public on April Fools' Day — the day before four of the senators (Riegle was a surprise no show) met with Bank Board Chairman Gray at Keating's request to urge Gray not to take any action against Lincoln's violation of the rule.

The Keating Five waged Keating's fourth political campaign against the direct investment rule. The context of the campaign was the Bank Board's effort to "recapitalize" the Federal Savings and Loan Insurance Corporation ("FSLIC Recap) in order to secure funds to further its top priority — closing the fraudulent S&Ls like Lincoln. The FSLIC Recap bill had a second vital element — it would restore the Bank Board's lapsed powers to close many state chartered S&Ls like Lincoln. This meant that Keating had a vital need to block passage of the bill.

Senator Cranston, at Keating's request, blocked passage of the bill in the Senate by placing a secret "hold" on the bill. House Majority Leader Jim Wright, D-Texas, and Representative Pryor openly blocked the bill in the House. Wright extorted Gray, demanding favorable treatment for Texas frauds Pryor, demanded that fewer Arkansas S&Ls be closed and sanctioned. (He would later serve on the Senate ethics committee investigating the Keating Five — so they truly had a jury of their peers!) FSLIC Recap was the Bank Board's ultimate priority. The FSLIC fund was down to \$500 million — to insure an industry of over \$1 trillion in liabilities that was insolvent by perhaps \$100 billion in 1986. The S&L frauds' political allies had total leverage over Gray and he

repeatedly made concessions demanded by Majority Leader (and Speaker of the House in January 1987), Jim Wright. The CEOs of each of the S&Ls that Wright sought favors for were looting "their" S&Ls — including Vernon Savings (after Lincoln, the worst S&L fraud).

Keating knew that adding the Keating Five's political clout in the Senate to Speaker Wright's domination of the House would doom the FSLIC Recap bill (which was reintroduced in 1987) and put irresistible pressure on Gray to back off from taking enforcement action against Lincoln. He made the threat explicit by telling Undersecretary Gould that he could induce five senators to either be a great help or strong opponents of the FSLIC Recap bill. (This is the conversation that caused Gould to bar Keating from the Treasury building.) By April 2, 1987, Speaker Wright's House allies had made a travesty of the FSLIC Recap bill — reducing the funding from \$15 billion to \$5 billion and mandating "forbearance" provisions designed to gut the Bank Board's ability to close failed S&Ls. Our only hope was that the Senate would pass a better version of the bill and that the conference committee would favor the Senate version. Keating had arranged for the Keating Five to pressure Gray at exactly the time they had maximum leverage over him.

Keating Prepares the Senators for the April 2, 1987 Meeting

Keating prepared the Senators carefully for the April 2 meeting. He sent them detailed explanations of how severely a Bank Board enforcement action would limit his ability to control Lincoln. He explained how passage of the FSLIC Recap bill would allow the Bank Board to end that control. He called Gray a "Mad Dog" and a "Nazi." He asked the Senators to convince Gray not to take any enforcement action against Lincoln in return for his promise that Lincoln would begin to make home loans.

Senator DeConcini hosted the April 2 meeting. He carefully set up the meeting for deniability. His staff instructed Gray not to bring any staffers. Each of the Senators came to the meeting without any staff. The chances of that happening without prior agreement were non-existent. The meeting was designed to make sure that if things went badly it would be the word of five senators against that of Gray. The senators thought there was safety in numbers. They were disturbed that Senator Riegle did not attend the April 2 meeting.

McCain's Attendance at the April 2 Meeting

Senator McCain has said that upon reviewing Keating's written materials about what he wanted the Senators to do in their meeting with Gray he decided that Keating's requests were improper because they called for the Senators to negotiate an agreement to escape enforcement action on Keating's behalf. McCain informed Keating that he would not attend the meeting. Keating met with Senator Riegle and told him of McCain's decision — and said that McCain was "a wimp." Riegle's aide told McCain what Keating had said. McCain, enraged, summoned Keating to his office. Keating, who dominated virtually every conversation, could not get a word in during McCain's tirade. Keating's insult, of course, was absurd. McCain is the last person in the world that anyone would believe was a "wimp." Keating, however, apparently knew how successful his taunt would be with a man who still felt (against all reason) that he had not always sufficiently resisted his North Vietnamese torturers. McCain, despite believing that what Keating wanted the Senators to do was improper, decided to join his colleagues at the April 2 meeting.

The April 2 Meeting

Senator DeConcini began the meeting by stating that "we" wanted Gray not to take enforcement action against Lincoln and that in return "our friend" Charles Keating would ensure that Lincoln would begin to make home loans. He was speaking on behalf of the group — and no Senator expressed any disagreement or difference with the position he articulated. The Senators also complained that the agency was harassing Lincoln and demanded Gray's explanation for the abuse. Gray told them there were 3000 S&Ls and he did not know the details of Lincoln's regulation, but that he had total confidence in the Bank Board's regulators for Lincoln at the Federal Home Loan Bank of San Francisco (FHLBSF). He said that if the Senators needed the details they would have to talk to the FHLBSF supervisors. Gray informed several of us at the Bank Board of what had

happened at the meeting immediately after the meeting.

The April 9 Meeting

All five of the Senators attended the April 9 meeting with James Cirona (FHLBSF President), Michael Patriarca (chief supervisor), Richard Sanchez (Lincoln's supervisory agent), and me. I took the only notes of the meeting. They are extraordinarily detailed. I circulated them to the other FHLBSF participants to ensure their accuracy and Gray sent Riegle a copy. Each of the Keating Five testified that the notes were accurate and complete. The Senators again excluded their aides from the meeting. Senator DeConcini began the meeting by again using the word "we" and proposing Keating's "quid pro quo" of dropping any enforcement action against Lincoln's violation of the direct investment rule in return for Lincoln making some home loans. No Senator disagreed or distinguished his position.

Senator Cranston accentuated the group nature of the Keating Five. He was the floor manager for a bill that was very important to him and was coming to a critical vote that night, yet he left the floor and came briefly to Senator DeConcini's office to state that he supported his colleagues' position. Each of the Senators was aware of the group position supporting Keating's efforts to immunize the massive violation of the direct investment rule.

At the meeting, because it was the only way to treat to get the Senators to back off their pressure, we revealed to them that we had decided to make criminal referrals against Lincoln's leaders because of widespread fraud. Mike Patriarca guaranteed that Lincoln would fail if it continued its investment practices.

The Keating Five Prove Lucky in their (Initial) Regulatory "Opponents"

The paradox is that the Keating Five proved so unlucky in their choice of Keating as their ally and so lucky in their initial regulatory "opponents." We were not the Keating Five's opponents, but that is how they perceived us. We were their public servants trying to warn them that they were being manipulated by a fraud that was causing enormous harm to their constituents and exposing the Senators to scandal. Had Gray caved, Lincoln would have been untouchable. Lincoln would have been able to resume its extraordinary growth and expand its direct investments. No line supervisory would have dared to take on Keating. Lincoln's losses would have grown at an even faster rate than its asset growth. By the time it collapsed losses would likely have exceeded \$10 billion. The Keating Five's decisive role in producing these catastrophic results would have been undeniable. Gray, however, refused to be intimidated. Keating's timing, which had seemed so perfect, proved too late. Gray had decided that Speaker Wright simply increased his demands when Gray gave in to his extortion, and that he could not in good conscience continue to give in to Wright's pressure. The Bank Board moved to close Vernon Savings (the second worst S&L fraud) and publicly criticized Wright's efforts to secure regulatory favors for Vernon.

The Senators also proved lucky in that, while Gray did not cave in to their pressure, he also could not afford to criticize them publicly given the tenuous fate of the FSLIC Recap bill. Gray's term ended on June 30, 1987. (Wright and Treasury Secretary Baker had agreed at a secret meeting that Gray would not be reappointed.) Gray's successor, Danny Wall, was acceptable to Wright. Wall, while a Senate staffer, had encouraged Gray to give in to Wright's extortion. Among his first acts was to issue a gag order forbidding me to speak to the press.

The Keating Five Prove Unlucky in Allying with Keating

Keating proved to be the worst of the S&L looters, and Lincoln the most expensive failure at \$3.4 billion. Deposit insurance meant that there were no identifiable individual victims when S&Ls failed. Lincoln's parent company, however, sold uninsured, worthless junk bonds out of Lincoln's branches. Worse, it targeted widows. This created individual victims who lost their life's savings — and the face of the victim was your grandmother. Keating then compounded the Senators' problems. The Associated Press recently reported the story as follows:

The banker's attitude was summed up the day a reporter asked whether his political donations to the senators

encouraged their intervention.

"I want to say in the most forceful way I can, I certainly hope so," Keating replied.

The AP quotation is correct, and it is obviously the worst possible thing Keating could have said from Senators' perspective. The first sentence of the AP story, however, is wrong, and it shows that the reporter did not grasp the trait that made Keating the worst of the looters — audacity. Keating called a press conference, but he did not allow the reporters to ask any questions. He read written answers to questions he had prepared. This was a planned statement, not off the cuff.

Keating adds Speaker Wright's Pressure to that of the Keating Five

Wall, the self-described "child of the Senate", came into office determined to avoid conflicts with powerful politicians. He promptly ordered the FHLB examination and the enforcement investigation of Lincoln halted. Both actions were unprecedented. They followed a meeting between Bank Board staff and Lincoln's leadership. The FHLBSF was not informed that the meeting would occur. It was consulted prior to the order to stop the examination. Wall then ordered that the agency re-examine the FHLBSF's findings. This was unprecedented. The review disappointed Wall because it supported the FHLBSF's findings and found no basis for Keating's complaints against the FHLBSF. Despite these facts, the Bank Board refused to consider the FHLBSF's recommendations to place Lincoln in conservatorship or take stringent enforcement actions based on the violation of the direct investment rule and fraudulent acts. (FSLIC Recap passed in August 1987, and restored the Bank Board's lapse conservatorship powers.)

The Wall Bank Board also refused to be briefed by the FHLBSF on its recommendations. Both refusals were unprecedented. Wall then sought to induce the Federal Home Loan Bank of Seattle (FHLBS) to permit Lincoln to transfer to its jurisdiction. The FHLBS declined, stating that it agreed with the FHLBSF's concerns and that they were disturbed by Keating's response to their question of why he was neither an officer nor board member of Lincoln: "I don't want to go to jail." This action was unprecedented. While the Bank Board Chairman Wall and Board Member Martin declined to be briefed by the FHLBSF, they met several times with Keating. This was unprecedented.

When Bank Board and FHLBSF staff members were to meet with Keating in early 1988, Keating demanded that I be excluded from the meeting, and the Bank Board acceded to his demand. At another meeting with Lincoln's leaders the FHLBSF was allowed to have only one representative present — and only on the condition that he would not be permitted to speak. All of these actions were unprecedented.

Remember that by this juncture the Bank Board had confirmed that Lincoln had committed the largest violation of a rule in history, was engaged in widespread forgeries and other forms of deception that had led the agency to file an extensive criminal referral, was investing primarily in assets (direct investments) in quantities that had proved fatal in every S&L, and was growing rapidly. By any logical standard it should have been the agency's top enforcement priority. Instead it got unprecedented favors that destroyed the agency's integrity and exposed the taxpayers to enormous losses. Fear of Keating's political power was the only possible explanation for these actions. James Boland, Wall's chief of staff, emphasized this fear in discussions with the FHLBSF's top supervisor, Michael Patriarca. He said that Keating was so powerful that: "he can get you in ways you'll never know you've been got."

Keating's and Wall's mutual problem, however, was that the FHLBSF refused to back down. Keating's top priority became another unprecedented demand — Wall must remove the FHLBSF's jurisdiction over Lincoln. Keating now used the Keating Five to recruit Speaker Wright as an ally and to make Wall aware of that alliance. He used Senator Cranston to set up a late afternoon meeting with Wall for January 28, 1988. He used Senator Glenn to set up a luncheon with Speaker Wright on the same day. At the luncheon meeting Keating experienced the second occasion in which a prominent politician dominated the conversation. Speaker Wright dominated it, denouncing Gray and me. The Speaker then invited Keating to come to his chambers and work with his staff. Wright urged Keating to get me fired and to sue Gray and me. (He soon sued both of us for \$400 million — suits eventually dismissed by the courts.) When Keating met with Wall he first made clear that he had

just come from a meeting with Speaker and Senator Glenn. Keating next told Wall:

That is one man in Congress you would get along with much, much better if you took care of the problem in San Francisco. There is a red-bearded lawyer that's a real problem. If you took care of that problem, you would get along much better with Speaker Wright.

Keating was referring to me. Unfortunately, for Keating (and Wall), Wall could only fire me "for cause" and he had no cause. The only way to take care of the problem was to remove the FHLBSF's jurisdiction over Lincoln Savings. Wall promptly ordered his staff to reach an "amicable resolution" with Keating. The only way to do that was to remove our jurisdiction. In addition to that unprecedented act (which sent shock waves throughout federal regulators), Wall agreed that the FHLBSF's examination findings (which the Bank Board had confirmed to be accurate) could not be used. This too was unprecedented.

The result of Wall's surrender to political intimidation was devastating. Lincoln remains the most expensive insured depository failure in U.S. history. Lincoln's parent defrauded over ten thousand widows. The Bank Board's reputation was destroyed (the 1989 legislation terminated it). Wall, of course, denies that he capitulated to Keating's political power. To admit that he did so would have destroyed Wall's efforts to remain head of new S&L regulatory agency. The facts, however, falsify Wall's denial. Note that the Wall Bank Board never took any enforcement action against Lincoln's massive violation of the direct investment rule even though it agreed that it was the largest regulatory violation in the agency's history. This immunity is precisely what Keating sought to achieve through his mole's (Lee Henkel's) proposed amendment to the direct investment rule and the Keating Five's effort to induce the Bank Board not to take an enforcement action in return for Lincoln beginning to make home loans.

McCain's Relationship with Keating

Senator McCain is the only member of the Keating Five still in office. He was unique among the group on several dimensions. He was the only Republican. He had the longest, closest relationship with Keating. The relationship was social — Lincoln's airplanes flew Senator and Mrs. McCain, their children, and a nanny to stay at Keating's vacation home in the Bahamas. Senator McCain blames his failure to reimburse the expenses (which he was required to do by law), on his staff. He reimbursed only years later after the scandal broke. No other Senator had a close social relationship with Keating or similar airplane use issues. Keating was a bully and a nasty bigot, whom many politicians refused to deal with once they knew him, but Senator McCain viewed him as a personal friend (and major contributor) for a decade.

Only Senator McCain (and Lee Henkel) had a financial conflict of interest involving the direct investment rule. Senator McCain's wife and father-in-law were engaged in a direct investment with Lincoln. Had the Bank Board taken enforcement action against Lincoln's violation of the direct investment rule Senator McCain's wife and father-in-law's investment would have been placed in substantial risk of loss.

Only Senator McCain was in the House at the time Keating enlisted a majority of the House to co-sponsor his resolution designed to kill the direct investment rule. He was the only member of the Keating Five, therefore who was a co-sponsor. More generally, Senator McCain was the Senator most opposed to financial regulation in general and Gray's "reregulation" of S&Ls in particular. As his March 25, 2008 speech on the ongoing mortgage crisis makes clear, he continues to call for greater deregulation of the kind that is causing our financial crises to become more severe and more common.

Senator McCain's efforts to convince the Reagan administration to give Keating de facto control over the Bank Board by appointing two nominees chosen by Keating to run the agency were not unique among the Keating Five, but he was the most important support for Keating's effort because he was a Republican.

Senator McCain was not unique in not giving direct aid to Keating after the April 9 meeting. It is important to consider how Keating shaped Wall's perspective of the Keating Five's support. He used both Senator Cranston and Senator Glenn's active, continuing support (in February 1988, almost a year after the April 2 and April 9, 1987 meetings) to show Wall that he retained the Keating Five's loyalty and he used Senator Glenn to help recruit Speaker Wright as an ally — knowing that Wall had advised Gray to give in to Wright's political pressure.

Wall had no way of knowing that Senator McCain and Senator Riegle were no longer taking affirmative actions to help Keating get the Bank Board not to bring an enforcement action against Lincoln.

Omission and Commission

None of the Keating Five members helped protect their constituents by supporting regulatory efforts to end Keating's looting of Lincoln. We told them in fair detail at the April 9, 1987 meeting that it was a fraudulent institution and that it was guaranteed to fail if it continued its policies. The Keating Five were well aware of their political power and Keating's political power. They were aware that the Wall Bank Board was taking unprecedented actions in favor of Keating. We could not act. We were gagged. We were forbidden to examine Lincoln. We were excluded from meetings or ordered to remain silent. The new examiners were forbidden by Wall to speak to us about Lincoln.

I noted that the senators structured the April 2, 1987 meeting to ensure deniability by designing it to be the word of five Senators against one "bureaucrat" should things go wrong. They knew that the meeting was dangerous because they knew agencies are supposed to take stringent enforcement actions against massive, intentional violations of rules — particularly when the nature of the violation causes failures. They also knew that Keating's mole, Lee Henkel, had just resigned in disgrace after we had blown the whistle on his attempt to immunize Lincoln's violation of the direct investment rule. This is why they excluded all staff from the April 2 meeting. When the meeting became public, along with Gray's criticism of their effort to pressure him to agree to Keating's quid pro quo deal, each of the Senators lied about the meeting. They lied by claiming that Gray had lied about their support for Keating's deal. (Eventually, it emerged that Senator DeConcini was reading from a staffer's memorandum that expressly stated the quid pro quo.)

The Senate ethics committee ignored the Senator's false statements about the meetings. (It also failed to investigate the impact of the Senator's actions in Keating's behalf.) I believe that structuring a meeting to set up a lie, lying, and defaming another person you know has told the truth (i.e., claiming that Gray's statement about the quid pro quo proposal was false), demonstrate severe character flaws and should be considered unethical in the context of the U.S. Senate.