SENATOR RUDMAN: We will allow him to proceed on this basis, but I would make the observation this is not a meeting of the Banking Committee. Much in the statement is of interest to the American people, but of very little interest to the Committee, who already is aware of the whole perspective.

So, proceed, Mr. Gray. I have given you the oath. You are now under oath and you may proceed.

MR. TAYLOR: Are copies available for counsel at some location in this room?

SENATOR RUDMAN: I wonder, Mr. Garment, if you would have one of your associates pass out copies of the statement to Mr. Green and Mr. Dowd, Mr. Ruff, Mr. Hamilton and Mr. Taylor.

The Committee does have copies. It is in the record. And you may proceed with your statement.

MR. GRAY: Mr. Chairman, members of the Committee, Special Counsel Bennett and ladies and gentlemen, I come before you today at your invitation as a witness.

I know you will be asking questions today about whether or not certain Senators put undue pressure on me in my capacity as head of the Federal Home Loan Bank Board. In order to answer that question, I believe you must know something about the political situation in which I found myself in April, 1987.

The savings and loan system was created in the early 1930s under federal statutes to encourage personal saving and home ownership. As part of these statutes, Congress insisted that home mortgages be made at long-term, fixed rates of interest. In the early '80s, when interest rates climbed to unprecedented levels, hundreds of S&Ls failed because what they earned from their fixed-rate mortgages was less than what it cost them to attract and retain savings deposits. The federal government chose to respond by further deregulating the thrift industry in 1982.

With enactment of the Garn-St Germain Act in the fall of 1982, Congress allowed federally chartered S&Ls to move far more heavily into commercial lending, especially commercial real estate lending.

California and other States, especially across the sunbelt, went much further with their liberalization. California, for example, enacted a law authorizing its S&Ls to go into any kind of business they wished.

California and other States went beyond the federal law and gave their S&Ls the right to use federally insured deposits to play the stock market or to buy and run any type of enterprise the mind can conceive of, including real estate speculation.

These especially liberal sunbelt State laws for State-chartered thrifts attracted a new breed to the S&L business.

These so-called entrepreneurs had the mentality of the venture capitalist. While the temperament may be legitimate, it also can be very dangerous in the absence of a strong commitment to fiduciary responsibility by the operator of a publicly chartered thrift.

Almost all of the capital these new S&L entrepreneurs were putting up for these ventures was not their own. It was other peoples' money, and the government stood to make up the loss if their endeavors failed.

Their venture capital was, almost completely, federally insured deposits. If their S&L enterprises succeeded, these thrift operators would be rewarded handsomely.

If their ventures failed, the Federal Savings and Loan Insurance Corporation -- that is to say, the taxpayers -- would be required to pay all the losses. In other words, heads they would win. The taxpayers would lose, if it came up tails.

Moreover, two years before the Garn-St Germain Act, the government had decided to increase its insurance coverage to $100,000 per account. That was in 1980. This move greatly raised the taxpayers' ultimate exposure to the risk of loss, and to actual losses.

When I arrived to become chief thrift regulator in May, 1983, a burgeoning new industry -- that of the money brokers -- was pouring new money, which were called brokered

deposits, into the newly deregulated thrift system.

The brokered deposits were federally insured if the venture capitalists' projects crashed.

Much of this money was going to the thrifts paying the highest interest rates. These high-interest S&Ls, not surprisingly, were often run by the new breed of thrift operators, particularly those who didn't want to stick to making home mortgages. The brokered deposits often went to weak thrifts which couldn't really afford to pay the high rates the money brokers were asking.

Weak thrifts took the money anyway:

After all, the deposits were federally insured. Almost as quickly as the money arrived, it was lent and invested in often very speculative endeavors, many of which went bad.

When Congress and the various States deregulated thrifts, nothing was done to strengthen the regulators' ability to keep tabs on how all this federally insured money would now be used. California reduced its professional regulatory staff to a few dozen in number, notwithstanding the fact that it had given its thrifts the most liberal banking law in history. The Garn-St Germain Act -- the federal thrift deregulation law -- made no provision whatsoever to help the regulators cope with the altogether new, and frankly dangerous, thrift operating environment.

The agency I headed, unlike the FDIC and the Federal

Reserve System -- let me emphasize that we were not like the FDIC and the Federal Reserve System in this regard -- was supervised by the Office of Management and Budget and the Office of Personnel Management. OMB controlled our budget.

OPM set the salaries. The Bank Board was consistently denied any help at all by OMB in obtaining meaningful increases in staff and by OPM in setting salary levels which would be high enough to attract and retain staff.

For example, OPM would allow us to pay an entry-level examiner only $14,000 a year at most, and our examiner turnover rate was, naturally, horrendous. Half of our examiners had less than two years experience on the job. Yet, we were directed by law to stay on top of events in an industry which held almost a trillion dollars in increasingly risky assets and which had virtually no tangible net worth to cushion against losses.

Meanwhile, FSLIC's reserves were being depleted by losses from bad assets, a problem fueled by rapid growth in insured deposits. Moreover, the ratio of FSLIC reserves to insured deposits was deteriorating steadily.

I began warning bout this state of affairs not long after I took office. Indeed, I warned of the consequences to come so often and continuously that I became known as Chicken Little and as an alarmist. During my term at the

Ban Board, those who opposed my policies dismissed them -- and me-- by saying that I was no expert in these matters.

I did not come to my position on the S&L crisis because I was an accountant or lawyer or financial guru. But I did have good judgment, honest instincts and the capacity to work hard. I relied on basic common sense and I had a skilled and conscientious staff. The information they continued to provide me made it chillingly clear that the FSLIC and the thrift system were doomed without major regulatory and statutory reforms.

As Bank Board Chairman, I tried to restrict brokered deposits, to require thrifts to grow no more than their earnings justified, to rein in the high flyers in the industry, to get rid of dangerously inflated accounting, to increase capital requirements, especially against risky assets, to classify assets appropriately, and to toughen appraisal standards. These initiatives all met stiff resistance from many in the thrift industry.

The very powerful and financially generous thrift lobby in Washington defeated every effort we made on Capitol Hill to achieve statutory reforms of the thrift system that would have taken the agency out from under OMB and OPM, or gained authority to impose risk-based insurance premiums against high-risk activities, or limited state thrift powers to those permitted by Congress for federally chartered thrifts,

and granted much tougher enforcement powers against imprudent and crooked S&Ls.

For two years, the Bank Board importuned Congress for legislation to bail out the insolvent FSLIC. Such legislation was the necessary centerpiece of any plan for thrift reform. The reason was simple:

If FSLIC did not have enough money, we could not pay off the depositors of the thrifts that were bankrupt but still open, doing business, and continuing to lose money at an exponential rate.

We had started calling these institutions "zombie" thrifts, because they were the walking dead of the industry. And if we could not pay off their depositors, we could not close these S&Ls that were bleeding money -- ultimately, the taxpayers' money -- at a massive rate.

When the bill finally passed, after my term of office expired, it was so watered down by congressional delay and weakening compromises that it was far too little and much too late. This inadequacy is another legacy of the powerful and generous thrift lobby, in Washington.

Near the beginning of this drama, in March, 1984, Charles Keating's American Continental Corporation bought Lincoln Savings, a California state-chartered S&L. California law then permitted direct equity investments:

Mr. Keating's S&L could buy companies and stocks,

participate in leveraged buyouts, build and run hotels, and own and operate real estate development ventures. Mr. Keating could easily raise the funds he needed to do such things, because Lincoln Savings, with its federally insured deposits, was a cash cow, well able to finance these endeavors. In 1984, Mr. Keating, in order to gain permission to acquire Lincoln, had assured state regulators and us that he would continue to operate the institution as primarily a home mortgage lender. Despite these assurances, he soon began using California's liberal thrift laws to their fullest.

One month after Mr. Keating acquired Lincoln, the Bank Board asked Congress to roll back state thrift powers to the boundaries set by the Garn-St Germain Act for federally chartered thrifts, population for. That is something Congress had done for federally-chartered thrifts.

This move would have severely curtailed direct investment authority for California thrifts. The Bank Board's request went nowhere. The Board began trying through administrative rule-making to limit the investment authority granted by California law, and Mr. Keating enlisted the first wave of paid apologists dedicated to preventing us from doing so. All this occurred before I had heard of Charles Keating.

The Bank Board adopted its first direct investment

regulation on January 30, 1985. It limited the amount of a thrift's assets that could go into direct equity investment to 10 percent, unless regulators permitted exceptions, to be granted only under specific conditions.

By the time of our rulemaking, Mr. Keating had apparently been lobbying heavily to try to insure that the rule wouldn't be applied against Lincoln or that it would be scuttled by a powerful show of force in Congress. Largely as a result of the Keating effort, more than half the members of the House signed a resolution intended to cause me and my colleagues to back down in the face of this demonstration of power. We didn't. The direct investment regulation stood.

Mr. Keating next sought to deal with his problem by hiring me out of my job as chief regulator. He tried to do so in a personal meeting with my chief of staff, who -- on my prior instructions -- rejected his proposal.

In 1986, it became clear that Mr. Keating was conducting a campaign, through his employees, agents, and sympathizers, to create the impression with the media and other influence molders that I was feuding with him.

Actually, I've never met him or even seen him in person. But we began hearing, nd then reading, that I was somehow conducting a "vendetta" against Lincoln.

A Gray-Keating feud story ran on the front page of The

Washington Post on September 20, 1986, in which it also was falsely alleged that I was "harassing" Lincoln. From that time forward, my senior staff and I believed that the alleged Gray "vendetta" was intended to be used by Keating as a basis for fighting the thrift regulators in the future.

"Vendetta" accusations were not the only pressure tactics I saw in operation that year. It was, we now know, not an accident that opposition to my efforts to warn about growing S&L problems coincided with the appearance of critical news stories about certain of the Bank Board's practices. When I arrived at the agency, these practices had been in place for over a decade.

The Regional Banks would routinely pay part of the expenses incurred by bank board officials, including myself, when we attended out-of-town conferences of the regional banks. These practices had been approved by Bank Board counsel on more than one occasion and were known to the Congress.

Despite this history -- and whatever may have been the source or motivation of the news stories -- I concluded that the questions raised in the news stories were not unreasonable, and that the public perceptions created by the news stories were not only hurting me but would, even if I survived in office, destroy any chance I might have at reforming the thrift system.

I therefore reviewed these practices, revised them and, without being required or asked to do so, paid back certain challenged expenses. I also reimbursed the cost of an airplane charter arranged for me by Regional Bank officials on the occasion of a severe medical emergency in my family.

The total amount of the reimbursements was approximately $27,000. This matter was thoroughly investigated by the Office of Government Ethics, the Department of Justice, and the Bank Board's Inspector General, none of whom recommended any remedial action against me. These attacks were part of a pattern of pressures meant to discredit me and derail the effort to achieve S&L reform. Senator Cranston's opening statement signaled that some would like this issue to play the same role at these hearings.

I hope it will not.

In mid-1986, the terms of my two Bank Board colleagues, Mary Grigsby and Donald Hovde, were due to expire. News reports speculated, as early as August, 1986, that two Keating associates -- Professor George Benston of the University of Rochester, a paid consultant to Lincoln since 1984, and Lee Henkel, a Keating lawyer and close associate who also was a major borrower of Lincoln's -- were being seriously considered by the White House under the leadership of Donald Regan to fill the Grigsby and Hovde seats on the Bank Board. Henkel was indeed given a recess appointment

for the Republican slot on the Bank Board in late October, 1986. This sent a very strong signal to me and the Bank Board staff that Mr. Keating had especially heavy political clout and that he intended to use it.

The pressures during those years came from the Hill as well as the executive branch and the media, and the congressional pressures were heaviest of all. Beginning in 1985, I had been asking Congress for a major recapitalization of FSLIC. That was in October of 1985.

Finally, in the fall of 1986, we had a recapitalization bill moving through Congress -- when suddenly it stopped. Incoming Speaker Wright had been told that our regulators were being too tough on Texas S&Ls owned by his constituents and contributors, and he, personally, was putting a "hold" on the bill until he could get some satisfaction. The delay was critical. It also impressed on all of us at the Bank Board, if we had not known it before, that congressional consent was the key to stopping the hemorrhage of the losses to the taxpayers.

Board member Henkel, in his first open meeting of the Bank Board, proposed an alternative regulation for our direct investment rule, which was due to expire. His version would have forgiven thrifts for certain massive violations of the grandfathering clause of the extant direct

investment regulation. We believed then, and I believe today, that Mr. Henkel's regulation was specifically intended to benefit Lincoln, and only Lincoln, Savings.

Newly appointed Board member Larry White and I voted against Henkel's regulation and for renewing our direct investment rule. Later, at the end of February, 1987, Mr. White and I voted to strengthen the direct investment regulation very substantially by tying a thrift's ability to make such equity investments to the level of tangible net worth on the books of the institution. Lincoln Savings thereupon sued the Bank Board on the grounds that we had exceeded our statutory authority.

On April 2, 1987, this issue of the direct investment rule came up in my meeting with Senators DeConcini, McCain, Cranston and Glenn, as to which I have already testified in my deposition.

Today, as we look back, it is clear many times over that the lion's share of the staggering losses the taxpayers will have to pay for are the result of overly rapid deposit growth, fueled in large part by money brokers, which went into equity investments, particularly those involving speculative real estate projects. Charles Keating's losses from direct investments and high risk land loans demonstrate beyond doubt that our regulatory concerns, our warnings and our actions were correct.

Charles Keating's purpose for Lincoln Savings was to use the institution as a source of funds for enterprises that had nothing to do with making home mortgages available for those seeking the American dream.

But there were many other thrift managements which, to a lesser or greater extent, were operating their thrifts for similar ends. Lincoln was not at all unique. These people played their political cards like masters in order to keep the regulators at bay. All the time, the stakes for the taxpayers continued to go up and up and up.

The technique did not intimidate me or my regulators, I am proud to say. But, it visited a crushing burden on both the taxpayers and those depositors and bondholders who had placed their trust in our regulatory system.

I hope this account makes clear that when I met in 1987 with the five Senators now before this Committee, we were not discussing a normal regulatory issue to be addressed through the normal kinds of pressure, negotiation and compromise.

This was a matter of clear and present danger to the nation and demanded a more sober treatment. We have heard a lot in these hearings about the responsibility of Senators to represent constituent interests, but I have always assumed that we also send our Senators to Washington because we think they will have the sense to know when narrow

constituent demands must take a back seat to the safety of their constituents as a whole.

I hope this recounting of events also makes clear that when I met with the five Senators, it was not in the midst of a normal political climate. These meetings capped years of private threats and public vilification designed not just to change particular decisions by the Bank Board but to render us unable to carry out our central responsibilities to protect the financial system and the taxpayers from loss.

No one in Washington with the slightest knowledge of this issue can have been ignorant of this situation or the effect it would have on the way the regulators received and interpreted messages from Senators and Congressmen.

Finally, I hope my experience makes clear that the savings and loan problem was not merely a problem of personal ethics among five Senators. There were hundreds of players in this political drama, each of whom had some sort of interest in preserving the existing system rather than changing it, and reforming it and making it safer and more sound.

This is the classic problem of a democracy:

The private interests fit together so closely and operate so powerfully that the public interest never gets served. They're beyond public interest, the ordinary folks out there. Their interest never gets served.

Perhaps this crisis will encourage us to build more safeguards against that danger.

Thank you.

SENATOR RUDMAN: Thank you, Mr. Gray.

It is now a little after 5:15. And, in light of the hour, rather than start on direct examination with Mr. Bennett, we will proceed to that at 9:30 tomorrow morning, with the hope that, if we are fortunate, we can get through your testimony and cross-examination during tomorrow. And, thus, not take too much of your time.

MR. GARMENT: We thank you, Mr. Chairman, for being able to make our statement.

SENATOR RUDMAN: I would ask the Committee to remain and meet in the conference room before you go to your own offices.

The Committee will stand in recess until 9:30 tomorrow morning.

(Whereupon, at 5:16 p.m., the Committee adjourned, to reconvene at the following day, Tuesday, November 27, 1990, at 9:30 a.m.)