

Cato Institute Policy Analysis No. 7: The Savings & Loan Industry: Averting Collapse

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Joe Stilwell

Joe Stilwell is pursuing studies at the Wharton School of Business.

Executive Summary

The financial health of the savings and loan industry has drastically deteriorated. The industry has a negative net worth in excess of \$70 billion, and it is experiencing significant liquidity problems. Through regulation and subsidy, government has caused large distortions in the financial markets. Regardless of changes in the economic climate, numerous S&Ls will be unable to meet their financial obligations. The federal government has three choices in dealing with the S&Ls: (1) Continue short-term "patching" policies, (2) Regulate other financial industries and/or fully support the S&L industry, or (3) Deregulate the S&Ls. Adopting the first will create additional misallocations in the financial system, and the industry will ultimately default on many of its obligations. Adopting option (2) will detrimentally affect other sectors of the financial community without addressing the fundamental problems of the associations. Again, the misallocations will grow. The third option will allow the healthy S&Ls to adapt, integrating themselves into the financial community. Most importantly, past mistakes will not be perpetuated, and insolvent institutions will be liquidated. Government's responsibility is to recognize its past mistakes before they become even more expensive to rectify.

Originally, savings and loan associations were formed in small towns by citizens interested in acquiring a source of capital for financing home building. Before the 1929 Depression, S&Ls lent individuals money only for a short period of time, usually no more than five years. Lenders felt that the risk of longer term mortgages could not be justified by the returns. During the first years of the Depression, the character of the associations was fundamentally-altered. In 1932, the Federal Home Loan Bank Act established the Federal Home Loan Bank (FHLB) system with 12 regional banks. The Home Owners Loan Act, passed in 1933, authorized a federal charter system. In 1934, the National Housing Act was passed, which established the Federal Savings and Loan Insurance Corporation (FSLIC).

The Home Owners Loan Corporation made 15-year mortgages possible and with the National Housing Act, 20-year mortgages became economical to issue. Risk was transferred from the mortgage lender to the government. Eventually, the standard 30-year mortgage came into existence. FSLIC insurance gave depositors confidence in the safety of their funds. A myriad of regulatory rulings by the FHLB Board set the associations' operations: They borrowed money from depositors through passbook accounts and lent it to home buyers in the form of 30-year fixed rate mortgages. The system seemed to work well, and few voices were raised against the regulatory restrictions. Home ownership became a part of the American way of life. Then the decade of the seventies shattered the mirage.

Volatility increased in the credit markets. For the first time in memory, the economy experienced both inflation and stagnation. Most economists, influenced by the ideas of John Maynard Keynes, had not foreseen these developments and could not explain them.[1] The health of the S&L industry slowly deteriorated. Interest rates reached levels above 15 percent. Then in 1980 the financial community began to buzz with talk of the industry's mounting problems. Now a campaign is being waged by regulators and industry officials to obscure the dangers facing the industry. Financial

publications claim that "the FSLIC has more than adequate resources to prevent any loss to depositors," that "when interest rates fall to more 'reasonable' levels, the industry will return to profitability," and "(the industry's) strong net worth position . . . shows its capacity to absorb considerable periods of adverse economic conditions" (from the U.S. League of Savings Associations' 1981 Sourcebook). None of these contentions is true.

The Condition of the Industry

To judge the industry's problems properly requires an in-depth analysis. First, it is necessary to understand the industry's present condition. Two factors display an individual S&L's, or the industry's, vital signs: Net worth and liquidity. Net worth is a measure of ultimate ability to pay all creditors. In the case of a financial institution, it means being capable of repaying all depositors as they attempt to make withdrawals. Net worth is an indicator of long-term viability, and liquidity is an indicator of immediate solvency.

According to industry spokesmen and government regulators, the aggregate net worth of all S&Ls slightly exceeds \$30 billion -- just under five percent of the industry's total assets. If one looks beyond the reported statistics, though, a much different picture appears. The institutions' aggregate net worth is not positive; it is actually negative. Accounting procedures have created a misleading facade.

Suppose that an S&L's balance sheet shows \$100 million in assets and \$95 million in liabilities, which leaves a net worth of \$5 million. A deeper analysis of the institution's assets, however, is necessary to obtain a realistic picture of net worth. If the assets have a dollar weighted average yield of 10 percent, if their dollar weighted average length of time until maturity is seven years, and if the market rate of interest for comparable assets is 18 percent, the actual value of all the S&L's assets (the amount for which they could now be sold) is approximately \$73 million -- significantly less than the official value. In this example, the assets, recorded at the price for which they were purchased, would sell for \$27 million less than their book value. Instead of a net worth of \$5 million, the S&L has a negative net worth of \$22 million, regardless of whether or not the loss appears on the firm's balance sheet.

The S&L industry's actual net worth position is somewhat worse. When interest rates rise, long-term financial obligations lose significantly more value than short-term obligations. Since S&L industry liabilities have a short-term structure, their market value is near their book value: \$630 billion. Recently, the average cost of industry liabilities stood at 10.31 percent. Because industry assets have a long-term structure, their actual value is much less than their book value of \$660 billion. At the same point, their average yield stood at 9.5 percent. The most optimistic figures suggest that at least a \$100 billion difference exists between the balance sheet figures and the market value of the associations' assets. In other words, the S&L industry has a negative net worth of roughly \$70 billion.

Newly issued mortgages will not significantly improve the situation. New mortgages are now being issued at record interest rates; many are being issued with interest rates that are periodically adjusted to bring their yield closer to the market rate. Because at first they will only make up a small percentage of an association's assets, however, the higher rates on the new mortgages will affect the industry's average asset yield of approximately 10 percent only marginally during the next few years. Retiring older, lower-yielding mortgages costs the same as holding them. Someone must bear the loss in value. Only a fall in interest rates, which will raise the value of secure long-term assets, can improve the industry's net worth position. The possibility and additional consequences of such a fall in rates will be examined later.

Liquidity, the second indicator of S&L health, is reaching an all-time low. Meeting demands of depositors for withdrawals has only been possible through extensive, short-term borrowing.

S&Ls receive most of their funds from depositors who can withdraw their money in six months or less. When more money is being withdrawn than deposited, the industry has a net withdrawal position and must liquidate securities or borrow to meet depositors' demands. Last June, a new record was set when net withdrawals reached \$5.8 billion. Never before had net withdrawals even remotely approached the volume of the last year. Clearly, this net withdrawal position portends the development of a dangerous situation.

One would expect that the industry as a whole would respond by selling its assets. Instead, the S&Ls are borrowing from the government in record amounts. The FHLB system extended an additional \$3.3 billion to the industry in July,

with total outstanding credit to S&Ls now at \$57 billion, an all-time high.

Since July 1980 the industry has grown from \$586 billion to \$635 billion. The FHLBs charge between 16 and 20 percent on cash advances, and it appears that the industry is willing to assume that cost while trying to lock in high yields in the expectation that interest rates will soon fall. Rather than sell assets and decrease its size, the industry continues to expand. The industry is using its borrowed money to issue new mortgages at all-time high rates.

The Role of Government

The S&L industry is a creature of government. Without subsidies it would never have grown to its present size. Without regulations it would not exist in its present form. The nation's financial system contains an ailing giant teetering on the brink of collapse, and government intervention is largely responsible.

Subsidies in the form of FHLB loans and deposit insurance have made continued growth in the industry possible when market forces dictated that the industry either adapt or limit expansion. Since regulations made significant adaptation impossible, some S&Ls would have gone bankrupt when market conditions turned against them. The industry would have reduced in size as it redeemed deposits. To illustrate this point, consider the automobile industry. At the beginning of the 1970s, some auto manufacturers foresaw the need for smaller cars. Others did not. When economic circumstances made small autos more profitable, those companies that planned accordingly prospered. Those that did not lost money and were forced to cut back their operations. The same type of events would have occurred in the financial industry if it were not for government subsidies.

In the 1960s, the savings and loan associations were still a solvent part of the financial industry. By maintaining short-term liabilities and long-term assets, S&Ls were, in effect, betting that the complex combination of events leading to higher interest rates would not occur. Without subsidies, as actual net worth of an institution fell and approached zero, investors would have demanded redemption of their deposits. The amount of deposits in S&Ls, and, consequently, the associations' size, would have decreased. The problem of negative net worth would have been eliminated before it could get worse, and only minimal losses would have been sustained by investors through bankruptcies -- in effect, doing away with distortions in the financial market. The S&L industry, as presently structured, would have contracted without serious detrimental effects on the rest of the financial industry.

Government subsidies changed the sequence of events and allowed the distortions in the market to grow. The first and most important direct subsidy to the S&L industry was deposit insurance. A subsidiary of the FHLB system, the FSLIC, insures up to \$100,000 of an individual's deposits at each S&L, a larger amount than in earlier years. S&Ls pay premiums to the FSLIC, but the cost is minimal. The federal government's guarantee against loss up to \$100,000 kept investors from withdrawing their deposits when the institutions' actual net worth approached zero. Individuals felt confident that the federal government would assure their timely repayment.

The second large direct subsidy is now rising to prominence. As mentioned earlier, outstanding loans from the FHLBs to S&Ls rise monthly. S&Ls are expanding, probably in an attempt to lock in high returns on long-term mortgages with FHLB advances. They were unable to get the same lending terms elsewhere. Net advances may soon well exceed \$60 billion. The sick \$580 billion industry that existed last year is now a sick \$630 billion industry. Without those government loans the industry would have contracted as it redeemed the deposits of investors concerned for the safety of their funds.

These two S&L subsidies kept the financing terms for residential real estate lower than market conditions dictated. From the Federal Home Loan Bank Act of 1932 to the Housing and Community Development Act Amendments of 1979 (with eight other major laws enacted during the intervening years), the result of federal legislation has been to lower the cost of home financing. Lowering the cost of financing enables the purchase price to rise while total cost changes little. But government subsidization of financing costs does not end with these 10 laws. The tax code itself makes home financing more attractive than other investment alternatives. Because mortgage interest payments are deductible, the effective interest rate for individuals in the top income bracket is roughly half the stated rate. Although the relative tax advantages are somewhat smaller for individuals in lower tax brackets, the advantages in relation to other investments still make real estate artificially attractive.

With the financing subsidies, more individuals purchased housing. Since financing, and not price, is subsidized, a person gains by acquiring as much long-term financing as possible when purchasing a home. With a greater demand for housing as a result of subsidies, prices have become artificially high relative to actual supply, and demand. Financing subsidies have increased the demand, supply and price of housing. The housing industry is now overextended and is dependent upon subsidies (and inflation) to avoid a collapse in demand and price. The subsidies are responsible for the growing distortions in the financial markets created by the S&L industry in the past 15 years. As the chosen instrument for federal housing policy implementation, S&Ls have become inextricably bound to the artificially high level of residential real estate prices.

Regulation also plays a prominent role in the industry's current plight. During the past few decades S&Ls were prohibited through both statute and regulatory ruling from offering consumer services such as checking accounts, corporate accounts, commercial and consumer loans, and credit cards. The complete list of restrictions is much more lengthy. Both directly and indirectly, S&Ls were forced to borrow money through short-term accounts and lend it for fixed returns on 20- to 30-year mortgages. If restrictions on the types of liabilities that S&Ls were permitted to issue had not existed, the associations' liabilities would have had longer maturities. Consequently, when interest rates rose, investors would have absorbed some of the losses suffered by S&Ls.

Deposit regulations have been particularly restrictive. Only five types of deposits permitted by the government have been well-received by the public: Passbook, NOW, six-month money market certificate, 30-month market rate certificate, and the jumbo certificate (\$100,000 minimum). Until this year, NOW accounts were largely prohibited, and prior to 1978, six-month money market certificates were prohibited. The industry possesses little liability flexibility.

If flexibility in issuing liabilities had not been severely diminished by regulations, prudent S&Ls would have extended the average maturity of their deposits by offering slightly higher interest rates on longer term deposits. (For example, in 1965, 20- to 30-year corporate bonds offered a yield less than 1/2 percent greater than immediately redeemable passbook accounts.) For a small price the industry's liabilities could have had a fluctuating market value tied closely to the market value of its long-term assets. Regulations insured that such a favorable situation did not materialize.

When changes in the financial environment made it uneconomical to continue the practice of "borrowing short and lending long," it took years to remove just a few of the regulatory restrictions. Many still exist. Timely adaptation to economic changes was impossible. As a direct consequence, the industry continued imprudent economic practices that have led to its present position, which has created the large distortion in America's financial markets.

Distortions in the marketplace can be viewed as unrealized -- but nonetheless real -- losses. They represent capital employed in an uneconomical manner; seldom can they be corrected without someone sustaining a loss. The loss represents the capital necessary to finance the obligations that cannot be repaid because the misallocated resources do not achieve the expected rate of return. Sometimes, the loss is met through infusions of additional capital. Often creditors sustain the loss through defaults on corporate obligations.

The Role of Interest Rates

To correct the distortions, industry officials and government regulators hope that interest rates will fall and eliminate, or drastically reduce, distortions. In effect, the hope is that circumstances will shift to the advantage of the industry and eliminate the necessity of anyone realizing the market losses. Events cannot unfold as they would like.

The value of a particular mortgage is determined in much the same way as the value of a bond. The primary factors, given a specified principal, are the market interest rate and the mortgage's degree of risk (the chance that money will be lost through a default). As the interest rate rises, investors demand a higher rate of return when purchasing mortgages. Also, when risk increases, investors require a higher rate of return to insure against possible losses. To increase the rate of return on a mortgage with a fixed interest rate, the mortgage price must decline. Consequently, whenever interest rates rise or the degree of risk increases, the value of that mortgage declines.

If interest rates continue to increase, S&L losses, both book and actual, will continue -- and accelerate. The rate of return required to sell mortgages will rise with the interest rate, and the value of all fixed-rate mortgages will fall. Holding mortgages until they mature will not change the basic situation. The losses will simply be recorded over the

lives of the mortgages as the difference between the interest paid to depositors who lend the S&L the mortgage principal and the interest received by the association on the mortgage. If interest rates go up, the value of the industry's assets will decline. Actual and book net worth will become increasingly negative. Even S&Ls that have preserved their financial integrity until now will develop a negative net worth. As the public perceives the magnitude of the situation, there will be more net withdrawals. Unless government makes up the decline in actual net worth, either directly or indirectly, depositors will lose money in S&L failures.

Unfortunately, if interest rates remain steady, the fate of many S&Ls will take slightly longer to resolve, but the outcome will not change. If rates remain near 18 percent, balance sheet net worth will approach actual net worth. Payments received on outstanding mortgages will be less than the interest expense on the deposits that provide the industry with the funds necessary to maintain those mortgages. That difference will be recorded as negative net earnings, and the negative net earnings will be reflected in a lower net worth.

Currently, almost 400 S&Ls are classified as having "substantial difficulties" by the FHLBB, an agency that has frequently underestimated the industry's problems. Further, the FHLBB's chairman, Richard Pratt, at a closed meeting of the President's Commission on Housing, recently predicted that if interest rates continue at current levels, one S&L will be reduced to zero net worth every business day. Despite official assurance, many individuals will begin removing deposits from S&Ls. Combined with net withdrawals caused by lack of privacy, poor service, and attractive investment alternatives (money market mutuals and others), this will create significant liquidity problems. Without large and timely subsidies from government agencies, many institutions will be unable to meet withdrawal demands. At best, many institutions will quietly fail.

The managers of S&Ls believe that a sharp fall in interest rates will restore their firms to profitability. If the rates fall, the value of long-term assets will rise, and disintermediation will decrease -- both necessary conditions for the industry's rebound. A temporary drop in rates, though, like the one in the first half of 1980, will not suffice. For the industry to continue to be viable the rates must remain low.

Today, there are two comprehensive schools of economic thought that analyze interest rates -- monetarism and Austrianism. Higher rates of inflation, i.e., monetary depreciation, lead to higher interest rates. The monetarists view interest rates as having two components: The real rate of return demanded on an investment and an inflation premium. In other words, if monetary depreciation is occurring at 12 percent per annum and the demanded real rate of return on an investment is 6 percent, the interest rate will be roughly 18 percent. The view of the "Austrian" school, led by F. A. Hayek, is somewhat more complex, but it also ties the interest rate to the rate of monetary depreciation (or, to be more precise, to expectations of monetary depreciation). Austrian economists hold that individuals lend money at a rate that they believe will exceed their costs of lending. Those costs include risk, time preference (the number of dollars at the future date of repayment that one values equivalently to the dollars now being lent), and the expected rate of depreciation in the currency's value during the lending period. Actually, the expectation of the rate of currency depreciation is an integral part of time preference.

The interest rate is positively correlated to the rate of monetary depreciation; that is, the interest rate rises as the rate of currency depreciation increases. This has serious implications for the S&L industry.

Eighty percent of the total assets held by S&Ls are long-term mortgages on real estate. The value of that real estate and the good faith of the borrowers serve as the only security for guaranteeing repayment of the mortgages. If the value of the mortgaged property falls below the loan amount outstanding, and if the borrowers default on their contractual obligations, the mortgages become worth the amount for which the properties can be sold -- an amount lower than the mortgages face value.

The Real Estate Market

The real estate market has been the prime beneficiary of decades of inflation. It is in a position somewhat akin to the position of the stock market in the late 1920s. During the 1970s the continuing monetary depreciation combined with tremendous federal financing subsidies to make residential real estate the largest and most profitable investment for the average person. As a tangible good, real estate is expected to roughly retain its real value. In an inflationary environment, its nominal value would continually increase. Demand rose because of housing's attraction as a perceived

inflation hedge, and real (inflation-adjusted) prices increased almost every year. The financing possibilities allowed intelligent investors to obtain extremely high leverage ratios while reducing their taxes to almost zero. Often, capital was doubled or tripled each year. Several "how-to" books on turning a few thousand dollars into several million made the New York Times Bestseller List. Thousands of investors became millionaires. Without monetary depreciation, sustained increases in real estate's real value would not have been possible.

Financing subsidies have increased the net supply of housing to a level far greater than market forces dictated (though regulations and other disincentives, which are outside the scope of this paper, may outweigh this effect). It now appears that neither demand nor price will be raised much further without expanding subsidies -- or increasing the rate of monetary depreciation. As shown earlier, rising or stable inflation will have a corresponding effect on interest rates, and that would mean that S&Ls would be forced to recognize \$100 billion in mortgage portfolio losses. The industry would be decimated.

Naturally and artificially induced demand have not increased in magnitude for several years. Their stimulative effect on housing prices has been exhausted. Only inflation keeps real estate prices rising.

However, many investors' plans hinge upon their expectations of rising real estate prices. If inflation were to stop, they would realize that no appreciation in price will occur and sell their properties in search of better investments. As demand falls, so will prices. Highly leveraged real estate speculators will be forced to sell and many individuals with combined mortgage debts larger than the new lower values of their real estate property will default. The resulting glut of houses for sale will create a downward spiral in real estate prices. Defaults will occur on many of the long-term assets of the S&L industry, and mortgage security will be insufficient to pay off the mortgages. The magnitude of the defaults cannot be determined, but it is likely to be substantial by almost any standard.

Industry officials and government regulators claim that a fall in interest rates will make S&Ls financially sound, but a sustained drop in interest rates is only possible with permanent decline in the rate of monetary depreciation. That decline will cause a drop in the value of the security of 80 percent of their assets. Resulting defaults will deplete a large proportion of industry assets. Many S&Ls will face liquidity problems as incoming cash flows are interrupted and net worth is depleted by defaults. As in the other two interest rate scenarios, many S&Ls will be incapable of meeting their financial obligations.

Government regulations and subsidies now play such a large role in the associations' affairs that the course of the industry's fate is inextricably linked to government decisions affecting the industry. The government has three courses of action available: 1) continue shortterm "patching" policies; 2) regulate other financial industries and/or fully support the S&L industry; or 3) deregulate the S&Ls.

In the late 1960s, before government began increasing the frequency and magnitude of its financial ventures, interest rates were well below five percent. Since the S&Ls' problems began mounting 15 years ago with the changes in the credit market, government has met each new problem with a temporary solution -- "patching" -- viewing each problem as isolated from the overall picture. Short-term actions are reflexive; they are aimed at maintaining the status quo. This is where the policy fails.

Saving the Industry

The status quo cannot be maintained without further regulating other segments of the financial system or increasing subsidies to S&Ls. Underlying the problems are fundamental flaws that can only be corrected by major changes in policy. Actual net worth evaporated years ago; record net outflows exist because of regulations limiting interest on deposits. Actual assets become a smaller percentage of liabilities almost every year. Even with large infusions of cash from the FHLB system, the industry now finds itself with tremendous liquidity problems. The regulators "solve" the worst cases by merging the least healthy institutions with the healthiest. This only postpones the day of reckoning. At present rates of balance sheet deterioration, within two years there will be few healthy associations available for merger. Loans from government will not change the long-term outlook. Whether their liabilities are deposits by individuals or loans from government, they still must pay interest on their borrowing.

Payment by the FSLIC to depositors at failing institutions can only cover a token amount of the difference between

actual liabilities and actual assets. The FSLIC has \$6-\$7 billion and a \$750 million line of credit with the Treasury to meet insurance claims as associations default. If trends continue, the FSLIC's funds will be depleted long before its insurance obligations are met. Should a number of S&Ls fail, the FSLIC will be of almost no help. Officials and regulators are attempting a magician's trick. They focus attention on the FSLIC's performance in the relatively stable past while diverting attention from the crucial point -- the FSLIC's capabilities in a volatile financial climate where S&Ls will go bankrupt in record numbers.

With any amount of patching, the same situation remains. Someone will eventually realize the loss on the industry's long-term assets. The FSLIC cannot cover more than a small amount of those losses; it can only postpone them. Unfortunately, the amount of unrealized losses grows larger as the fundamental problems remain unsolved.

Adopting the second option will put an even greater strain on the financial system. Distortions will grow, and the rate of saving in the economy will decline. By enacting new regulations for S&L competitors, or by taking a stance of complete support for the S&L industry, government would be altering the associations' fundamental problems. However, the effects on the economy would be destabilizing.

Regulation of other financial industries would mean some type of impediment. To encourage the inflows of cash into S&L associations, the other options available to investors must look less attractive than the return offered by S&Ls.

The S&Ls' most potent competitor, money market funds, is attracting large amounts of deposits from the S&L industry because the interest rate is higher, the minimum deposit amount lower, and there is no minimum length of time that funds must remain deposited. S&Ls only offer comparable rates of return on large sums of money or money deposited for a long period of time. Even then, the interest rate is often lower than the money market funds' interest rate. To induce more depositors to choose an S&L over a money market fund, regulations legally fixing a lower interest rate, a longer length of time for deposits, or a higher minimum deposit amount must be enacted on deposits with money market funds. Otherwise, individuals will not voluntarily switch from the money market funds to S&Ls. Any such regulation would detrimentally affect the investments of millions of individuals in the money market funds.

For the economy as a whole, there would be another undesirable consequence. To expand, the nation's economy needs investment. Since investment is financed through saving, if investment alternatives become less attractive, less will be saved. That is exactly what will happen should government attempt to increase the inflow (or decrease the outflow) of funds into the S&L industry by regulating its competitors.

The government could also increase support for the S&L industry. This approach would cost taxpayers many billions of dollars. The government could just make up the difference between actual net worth and actual liabilities. This would cost over \$70 billion and would set a dangerous precedent for the banking system. Or, using a more indirect approach, it could extend insurance coverage, increase FHLB advances, lower the interest rate on those advances, or give the S&Ls only part of the difference between actual assets and actual liabilities.

Each method is a form of subsidy and will be expensive. Subsidies will exacerbate the previous trend by increasing protection of the industry. Artificially aided, it will continue to grow, and there is no indication that the factors underlying the industry's financial disintegration -- rising interest rates, volatile credit markets, and insulation from poor business judgments -- will be corrected. Since support for the industry necessarily means support for individual S&Ls, additional subsidies will further insulate poor managers from the effects of poor decisions. The quality of management will decline. And such support will only perpetuate financial misallocations. The S&L industry would turn into a bottomless pit into which government pours huge sums of money.

The latest "subsidy" is the All-Savers program. Since tax is not paid on the certificates' first \$1000 of interest, S&Ls can acquire liabilities (sell certificates) at below market interest rates. The U.S. Treasury, though, is paying the cost for the less expensive funds flowing into the S&Ls. It loses the tax dollars on the interest that those funds would have earned if invested elsewhere. Given the present tax structure, the All-Savers certificates amount to a subsidy.[2] In an indirect way, government is mitigating industry losses.

[2] In actuality, tax relief is not a subsidy; it is the removal of a burden. When only one form of investment is exempted from taxation, however, the economic effect is virtually the same as that of a subsidy: Investments are channeled into one area that some investors would not have chosen without that incentive.

The program's structure, however, will not provide significant help to the S&Ls, and it will cost the Treasury tax dollars at a time when it can little afford such a loss. Either regulating the industry's competitors or extending further support to the S&Ls would be the government's most expensive option and the one most harmful to the economy.

Deregulation

The final option available is deregulation. This would entail an extension of, and numerous additions to, several reforms that have recently become effective through FHLBB rulings and the Depository Institutions Deregulation and Monetary Decontrol Act of 1980. Deregulation would reduce distortions in the financial system. However, additional consequences would appear almost immediately, and they would be painful for the economy.

Deregulation would eliminate laws governing lending and borrowing activities, interest rate ceilings, reserve requirements, mergers, and types of accounts. Every variety of competition that does not involve fraud would be legalized. That is the essence of true deregulation.

Within the past 18 months, a number of regulatory changes have been made by the FHLBB that move the industry, ever so slightly, toward deregulation. The changes have made it possible for greater issuance of variable rate mortgages, checking-like (NOW) accounts, consumer loans, and more flexible types of deposits. Predictably, these changes have almost immediately produced detrimental effects while benefits have not been as visible. But with deregulation, the problems are almost exclusively short term and the benefits long lasting.

In removing artificial barriers (those related to political, rather than market, forces), the strengths and weaknesses of institutions become much more apparent. Those depending on subsidies are forced into bankruptcy; those previously hindered in serving investors and consumers are freed to improve their service and long-term position. By looking at two related elements of deregulation, the difference between short-term problems and long-term benefits becomes apparent. Consider, for example, the elimination of restrictions on the terms of S&L assets and liabilities.

If regulations pertaining to maximum rates of interest on passbook accounts are eliminated, competition will raise the interest rate closer to market levels. Almost immediately, associations will lose a degree of profitability as the cost of their liabilities (investors' deposits) increases. Many S&Ls will quickly become insolvent.

The results of removing restrictions on assets are quite different in nature. Given a volatile interest rate climate and freedom to issue any type of loan, S&Ls will make a greater percentage of loans with floating interest rates. As rates rise, so will the yield on their portfolios. Since the new loans at first only make up a small part of the outstanding loans, the total yield on portfolios will not rise enough to keep up with the yields on deposits. With time, though, old loans will be retired, and new ones with variable rates will make up a larger proportion of S&L portfolios. Associations then will be protected against volatile interest rates.

As a result of the first steps taken toward partial deregulation, 1981 was a record year for mergers (an indication of the industry's financial insolvency). The insolvencies are largely the result of partial decontrol of maximum interest rates on deposits. If deregulation is extended to all types of deposits, we will see the same results on a much larger scale. Deregulation of loans and mortgages will take longer for the effect to be evident. In time, industry assets will increasingly consist of floating rate loans, and the earnings of S&Ls will stabilize. The associations that remain after the weakest institutions are eliminated will be stronger, more stable, and more responsive to customers' needs. They also will be viable without subsidies. Deregulation will lay the foundation for future industry stability.

Deregulation also will change the character of the industry. The distinctions between S&Ls and other financial intermediaries exist largely because of government restrictions. Deregulation will eliminate those barriers. As a result, many S&Ls will diversify, while others will merge with various types of lending institutions. Diversification would reduce risk and increase flexibility. Whether or not industry characteristics change, the S&Ls will be adapting to meet the needs of borrowers and investors. Once artificial barriers are removed, they must meet those needs or face

bankruptcy.

The S&L industry must face a crisis, a crisis, though, that can only be postponed by actions that will increase the industry's problems. Forty-eight years ago, government began taking an active role in the associations. Now the results are obvious. Market valuations indicate that industry assets are not sufficient to cover industry liabilities. Liquidity problems are so severe that without infusions of cash from government, the industry would be in the process of self-liquidation.

Rising interest rates have brought the industry's peril to the financial community's attention. If rates remain steady or rise still further, market losses gradually will be reflected on the S&Ls' balance sheets, leading to bankruptcy. Lower inflation, leading to permanently lower interest rates, will drastically reduce the value of the security backing industry assets. The results of a decline in the inflation rate are likely to be every bit as detrimental to the S&L industry as sustained high interest rates would be. The latter point is crucial, but it has been largely overlooked. Regardless of the interest rate level, the industry's problems will not disappear.

More regulations or short-term solutions will postpone the problems, but the underlying factors will cause the misallocations to grow. Deregulation will result in many losses to investors as decades of financial misallocations are liquidated, but deregulation will also eliminate the underlying problems.

Unfortunately, postponing a crisis is easier than facing one. But the mistakes of the past must be recognized and rectified.