
Lessons from the Savings and Loan Debacle

The Case for Further Financial Deregulation

Catherine England

An April 28, 1992, *Washington Post* editorial warned, "Over the past decade the country has learned a lot about the limits to deregulation." The savings and loan crisis was, of course, one exhibit called forth: "Deregulation also has its price, as the savings and loan disaster has hideously demonstrated. Deregulation, combined with the Reagan administration's egregious failure to enforce the remaining rules, led to the gigantic costs of cleaning up the failed S&Ls."

Such editorials demonstrate that the S&L fiasco continues to be misdiagnosed. Unfortunately, this misdiagnosis is being applied by many to the ailing banking industry, and there are those who would introduce the S&L cancer into the insurance market and compound that industry's problems. In the absence of more careful attention to the roots of the S&Ls' problems, taxpayers may face further financial industry bailouts.

The S&Ls' experience yields three important lessons. First, excessive regulation was the initial

cause of the industry's problems. Second, federal deposit insurance was ultimately responsible for the high costs of the debacle. Finally, government-sponsored efforts to protect the industry only invited abuses and increased the ultimate cost of restructuring.

Prelude to Disaster

From the end of the depression through the 1960s, the S&L industry represented an important cog in the U.S. government's efforts to promote home ownership, but the operation of individual S&Ls was pretty cut-and-dried. S&Ls were required by law and regulation to gather the savings of households in short-term deposits and invest those savings in thirty-year, fixed-rate mortgages secured by property within a fifty-mile radius of the institution's home office. Savings deposits were federally insured through the Federal Savings and Loan Insurance Corporation, and there were a handful of state-sponsored deposit insurance funds. Regional Federal Home Loan Banks were available to lend member institutions funds at subsidized rates, and the industry had an official Washington advocate in the Federal Home Loan Bank

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Board. Life at an S&L was not particularly exciting before 1970, but owners could earn a reasonably stable living.

Unfortunately, those staid institutions contained some fundamental flaws. Before 1980 S&Ls did not face much "credit risk," because mortgages represent one of the safest forms of consumer debt. What credit risk they did face was compounded, however, by the fact that each institution served a limited geographic area.

More important was the "interest rate risk" embodied in S&Ls' operations. As long as interest rates remain fairly stable over long periods of time, borrowing short (raising passbook savings deposits) and lending long (writing thirty-year, fixed-rate mortgage contracts) can prove profitable. Interest rates on long-term contracts are normally higher than those on short-term instruments, and houses are often resold and hence refinanced before thirty years have elapsed. But the risks of such a strategy remain, and those risks finally came home to roost for S&Ls.

As inflationary expectations became more prevalent during the 1970s, interest rates became more volatile and generally followed an upward trend. Increased economic uncertainty coupled with rising interest costs depressed the housing market. Homeowners kept their houses longer. First-time homebuyers delayed their purchases. When houses were sold, buyers more frequently invoked the "assumable" clause in mortgage contracts that allowed them to assume responsibility for the remaining loan balance at the existing interest rate. Mortgage portfolios that had traditionally turned over every five years or so stagnated during the late 1970s and early 1980s, and S&Ls' earnings stagnated with them. In 1980 the average effective yield on S&Ls' portfolios was 8.79 percent, while the 1980 inflation rate stood at 12.4 percent.

Meanwhile, the industry also faced funding problems. The rates S&Ls paid depositors were controlled. Those interest rate ceilings were designed to protect S&Ls from high funding costs, but as the 1970s progressed, S&Ls' customers became increasingly disgruntled. Returns on savings of 5 1/4 to 5 1/2 percent fell far short when inflation exceeded 12 percent.

Fortunately for savers, there was an alternative. Money market mutual funds collected individuals' savings, pooled them, and then bought, among other things, large certificates of deposit (\$100,000 or more) from banks and S&Ls. Because there were no interest rate controls on those large CDs,

money market mutual funds could demand, and then pay, market rates of interest. Between 1978 and 1981 money market mutual funds grew from \$9.5 billion to \$188.6 billion in assets, and many of their customers came from banks and S&Ls.

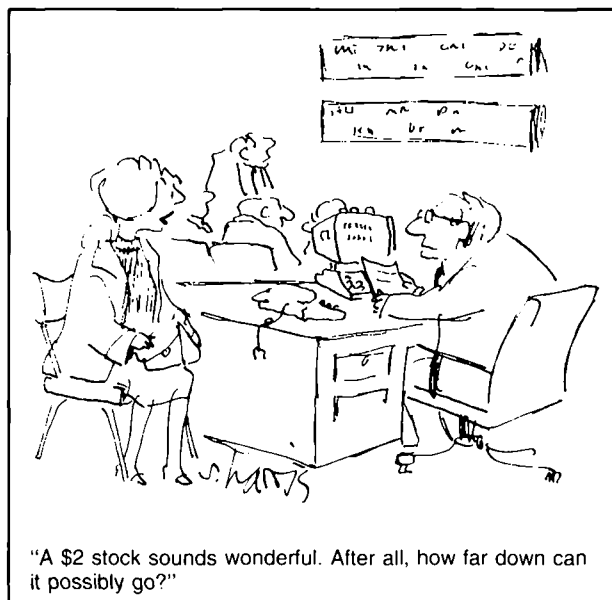
Excessive regulation was the initial cause of the S&L industry's problems. Federal deposit insurance was ultimately responsible for the high costs of the debacle. Government-sponsored efforts to protect the industry only invited abuses and increased the ultimate cost of restructuring.

Caught in a vise between stagnant incomes and rising costs, the S&L industry's capital eroded. By 1980, before any deregulation had taken place, the liabilities of the S&L industry exceeded its assets by \$110 billion. **The industry was already insolvent—its members owed more than they owned—when Congress and the Carter administration enacted the Depository Institutions Deregulation and Monetary Control Act of 1980.**

Resuscitation Efforts

Policymakers focused on the symptoms of the sick S&L industry in 1979 and 1980. To address the problems created by a portfolio full of long-term, fixed-rate assets, Congress and the administration sought to offer S&Ls additional investment opportunities. Thus, adjustable rate mortgages were finally allowed. The 1980 legislation and the Garn-St Germain Depository Institutions Act of 1982 also expanded acceptable S&L investments by permitting them to make short-term consumer loans, issue credit cards, and make commercial real estate loans, among other things. Policymakers hoped that broader powers would allow S&Ls to better diversify their portfolios so that they could increase their short-term earnings and be less vulnerable to future economic instability.

Policymakers also addressed S&Ls' funding problems. The 1980 legislation initiated a six-year phaseout of deposit interest rate ceilings and encouraged the development of new, longer-term savings instruments. In a last-minute conference



committee deal, Congress also expanded federal deposit insurance coverage from \$40,000 per account to \$100,000 per account.

Deregulation was a reasonable response to the S&Ls' ills. Overregulation had bankrupted the industry; it was logical to expect that greater freedom would enable S&L owners and managers to improve their financial health. Unfortunately, policymakers overlooked one crucial step—recapitalization.

In and of itself, deregulation was a reasonable response to the S&Ls' ills. Overregulation had bankrupted the industry; it was logical to expect that greater freedom would enable S&L owners and managers to improve their financial health. Unfortunately, policymakers overlooked one crucial step—recapitalization.

The Importance of Being Capitalized

When the corner grocery store or a national airline becomes insolvent, its creditors stop providing further support and force the business into bankruptcy court. Creditors limit their contributions to failing businesses, because as the owner's stake

in a firm declines, the owner becomes less cautious and more inclined to take greater risks in an attempt to recoup past losses and restore the firm to health. Such gambles sometimes pay off, but more often they only compound existing problems.

As the 1980s dawned, hundreds of S&Ls were insolvent. Unlike creditors of other businesses, however, savings and loan depositors, the primary private creditors of decapitalized S&Ls, continued to provide funding. Federal deposit insurance protected most S&L depositors from losses and made the federal government the creditor of last resort for weak institutions.

The federal government also failed to act as a private creditor would have acted. Government-sponsored financial support continued through both subsidized loans and continued deposit insurance. S&L owners with little or none of their own money at risk were thus given broad new powers and access to a virtually unlimited source of funds. The results were disastrous. In unravelling the events of the 1980s, it is helpful to consider three groups of S&L owners and managers: honest individuals operating weak or insolvent institutions, the crooks and frauds, and the owners and managers of healthy S&Ls.

Honest Managers of Weak Institutions. Imagine a fifty-year-old owner/manager of an S&L opened by his father. It is 1980, and he has helplessly watched his institution's capital erode. The housing market has slowed to a virtual standstill, and his customers have moved their savings to money market mutual funds.

He is unhappy with general economic conditions and the regulatory constraints that have caused his problems, and he wants his congressman and senators to know about it. In addition, he expresses the strongly held conviction that it would be wrong to close hundreds of S&Ls with financial problems not of their making. Then Congress acts, granting him permission to make loans and investments other than mortgages. In addition, the phaseout of interest rate ceilings is begun.

At this point, most S&L executives set out with every intention of restoring their institutions to financial health. But some fundamental realities face the management of insolvent financial institutions. Beginning from a situation where liabilities exceed assets, managers cannot overcome financial problems by pursuing a conservative

investment course. In the absence of a capital infusion to boost assets past liabilities (and return the institution to solvency), managers must substantially increase portfolio risk if they are serious about regaining financial health. In the 1980 and 1982 legislation, Congress provided the means for increased risk-taking while it ignored the need for capital investments. In fact, the legislation lowered capital requirements and revised the accounting rules so that the S&Ls' reported equity was artificially boosted. So why put more money at risk? Many S&L executives instead began to look for new lending and investment opportunities that promised high returns. It mattered little that most S&L managers were inexperienced in those new areas so that accurately assessing risk or prudently pricing new loans was difficult. If all went well, the institution would regain its financial health, and S&L owners had nothing left to lose if the new investments soured.

Given those conditions, it would have been surprising if S&L managers had not used their new investment powers to pursue higher returns through increased portfolio risk. When investments soured, S&L executives responded by raising more deposits and making new investments promising still higher returns. The industry's interest rate problem thus became a credit quality problem.

The rapid expansion experienced by S&Ls bent on "outgrowing their problems" would not have been possible a decade earlier. When computer technology was limited and deposit interest rates were strictly controlled, deposit markets were local markets. Depositors had no reason to send funds to S&Ls halfway across the country. Deregulation of deposit interest rates coupled with rapidly advancing computer technology changed that by making possible a nationwide market in deposits. That development was long overdue where small savers were concerned, and it improved the efficiency of U.S. capital markets. Unfortunately, expansive federal deposit insurance put insolvent S&Ls in a position to abuse the new market.

Weak institutions needed continued infusions of funds to pay operating expenses and to support increased investments. Meanwhile, federally insured depositors were largely unconcerned about the health of the institutions in which they placed their money. Undercapitalized S&Ls could thus assure themselves a continuing inflow of funds by simply offering to pay slightly higher interest rates than their competitors. Unlike other

industries, where failing firms find their funding dries up no matter what price they offer, insolvent S&Ls faced no such constraints. The 1980s were, in fact, marked by "perverse runs" in which funds flowed from stronger banks and S&Ls to the weakest depositories. For S&Ls, federal deposit insurance short-circuited the market's natural risk-braking mechanisms.

As the industry limped on, many longtime S&L owners and managers simply wanted out. One way out was to sell their S&Ls, and despite the industry's difficulties, there were eager buyers.

Crooks and Frauds. If Congress had set out in 1980 to create an environment that would lure all the crooks and frauds in the country into one industry, few industries would have been more suitable than the savings and loan industry. It was easy enough to find disenchanted S&L owners who were willing to sell out for a reasonable price, and once one had an S&L charter, opportunities abounded.

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Funding investment schemes was no problem. Enough federally insured depositors were indifferent to the uses to which their savings were put to supply effectively unlimited funds. More money was readily available by raising the promised interest payment. The absence of any market discipline meant that the task of overseeing S&Ls' investment decisions fell entirely to government regulators. Even under the best conditions, government overseers rarely show the same healthy skepticism as private investors, but for many S&Ls during the 1980s, the absence of supervision was particularly acute. The regional Home Loan Banks and the FSLIC, responsible for closing bankrupt S&Ls, were overwhelmed. Throughout the mid-1980s, while much of Congress chose to pursue a "head in the sand" strategy, S&L regulators lacked both the human and the financial

resources to deal with the hundreds of insolvent institutions around the country. Examinations were infrequent, and when improprieties were uncovered, examiners found it difficult to follow up in a timely fashion.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 made few distinctions between healthy and insolvent institutions. Many of the new investment powers granted earlier in the decade were lost to the entire industry, regardless of how prudently or profitably some S&L managers might have exercised them.

Despite those conditions, careful analyses have placed the losses caused by outright fraud (as opposed to second-guessing poor judgments) at only 3 to 10 percent of the total losses. In short, the lion's share of the \$200 billion lost (before interest) in the S&L disaster did not come from private greed run amok. The money is not stockpiled in secret offshore bank accounts, and aggressive criminal investigations will do less to protect taxpayers than a reduced role for federal deposit insurance and an increased resolve to see that undercapitalized depository institutions are closed promptly.

Fallout for Healthy S&Ls. Throughout the 1980s, one-third to one-half of the industry remained reasonably healthy. Whether the bulk of those institutions were better capitalized to begin with, more skillfully managed throughout that difficult decade, or just plain lucky has not been fully determined. Whatever factors contributed to their survival, it is important to consider how the government's response to insolvent S&Ls undermined the stability of well-capitalized institutions.

First, healthy S&Ls were asked to pay increasing deposit insurance premiums to protect depositors in failed institutions. Those rising premiums were not—and are not yet—risk-related. Thus, adequately capitalized, conservatively managed institutions effectively subsidized their high-flying brethren, and as premiums rose, the cross subsidy increased.

Second, healthy S&Ls' (and healthy banks') funding costs were increased by the continuing operations of undercapitalized and insolvent insti-

tutions. Sick institutions were willing to bid whatever was necessary to keep new deposits coming in the door, and as the "zombies" for which they were named, decapitalized S&Ls fed off their healthier counterparts.

In properly functioning capital markets, businesses or financial institutions taking less risk are able to attract funds with lower interest rates than their more risky competitors. For federally insured depositors, however, the relevant risk is not the risk that an individual bank or S&L will fail. Expansive federal deposit insurance effectively substitutes the government's credit rating for all insured institutions. For depositors placing \$100,000 or less in any single institution, all federally insured banks and S&Ls represent the same risk, and rational investors seek to maximize their returns for a given level of risk. Healthy banks and S&Ls consequently gained little or no cost advantage from the fact that they were well capitalized. To retain their customers, more conservative S&L executives often had to match the interest rates set by weak institutions. There is even economic evidence that the interest rates paid on Treasury securities were driven up by insolvent S&Ls as many investors viewed federally insured deposits and Treasury securities as close substitutes.

Healthy S&Ls' problems did not end with higher premiums and higher costs of funds, however. When federal regulators did get around to dealing with insolvent institutions, they often did not close them. Instead, the federal government would remove bad assets and inject capital before selling the S&L to new investors. S&L executives who had maneuvered through the worst pitfalls of the period then found themselves competing against counterparts revitalized by government monies. Meanwhile, no one offered to relieve solvent S&Ls of the burden imposed by their nonperforming loans.

When Congress and the Bush administration finally did resolve to deal with the industry's problems in 1989, owners and managers of healthy S&Ls were tarred with the same brush as the frauds. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 made few distinctions between healthy and insolvent institutions. Many of the new investment powers granted earlier in the decade were lost to the entire industry, regardless of how prudently or profitably some S&L managers might have exercised them.

A Case of Government Failure

Despite legislation to aid S&Ls in 1980 and 1982, most government officials continued to deny that there was a serious problem. The FSLIC received no injection of additional funds until 1987, and then those monies were inadequate. Furthermore, the Competitive Equality Banking Act of 1987 contained explicit forbearance language requiring regulators to leave open institutions whose problems were due to economic events beyond management's control. Why did government officials behave as they did? Surely, most policymakers did not set out to oversee a \$200 billion disaster.

In the late 1970s and early 1980s congressmen's long-time friends and acquaintances—acknowledged pillars of the community—approached them to seek relief for the industry. Losers in the early rounds of the crisis had a credible-sounding case. They had not lost their depositors' funds by extravagant lifestyles or gambles on high-risk investments. S&Ls' losses in the early going were the result of their faithfully serving the markets the federal government had asked them to serve.

A second force working in favor of forbearance was the nationwide, industrywide nature of the problem. Had Congress empowered regulators to take a tough stance from 1980 through 1982, almost two-thirds of the nation's S&Ls could have been closed. Virtually every congressman had one or more honest, hardworking S&L executives in his district who would have been adversely affected by such a decision. It is much more politically tempting to protect a troubled industry than a troubled firm.

Compounding the widespread desire to protect the good people of the S&L industry was a concern about the continued availability of housing funds in the wake of hundreds of S&L failures. Thus, homebuilders and realtors weighed in on the side of S&L executives lobbying for clemency.

The widespread tendency of political decision-makers to focus on the short term also contributed to their willingness to ignore the growing crisis. Policymakers eagerly accepted and repeated arguments that changing economic conditions—either regionally or nationally—would set conditions right before the next election.

In hindsight it is especially ironic that the Reagan administration, rhetorically dedicated to markets, could have condoned the forbearance policies that so short-circuited market discipline

where S&Ls were concerned. Unfortunately, during the early 1980s, many well-intentioned deregulators simply failed to grasp how thoroughly federal deposit insurance distorted the normal market checks on risk-taking. Deregulation of the airline industry improved efficiency because failure suddenly became a very real possibility for unstructured airlines. Deregulation of S&Ls seemed to fail because forbearance coupled with expansive federal deposit guarantees effectively eliminated the threat of failure.

Lessons and Warnings

The lessons available from the S&L crisis have important implications for ongoing policy debates where banks, insurance companies, and other financial institutions are concerned.

Lesson 1. The S&L industry's initial problems were caused by overregulation. The industrywide nature of the crisis was a direct outgrowth of federal regulation that defined the basic conditions under which all S&Ls operated. That prevented individual institutions from experimenting with different ways to adapt to changing market conditions.

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Regulators considering stricter definitions of "acceptable assets" for life insurance companies as well as opponents of more flexible operating rules for banks should take heed. Many banks are in trouble today because existing regulations have made it difficult for the industry to respond to emerging competitive pressures and changing economic conditions. Meanwhile, the life insurance industry's problems are as limited as they are because individual companies still have some freedom to make their own investment decisions. Mistakes are made, but not by all firms.

Risk is not avoided by having federal regulators establish operating rules; it is simply changed. The government's often-acknowledged sluggish response to changing conditions introduces new risks, and those government-created risks apply across the industry. The role played by overregulation in the initial stages of the S&L fiasco should not be overshadowed by the losses generated later in the decade.

Lesson 2. George Kaufman recently observed, "Deregulation is only effective in increasing efficiency if the reduction in government discipline is replaced by a compensating increase in market discipline." For insolvent S&Ls during the 1980s, there was no market discipline. Neither owners nor depositors had anything to lose, and both groups encouraged escalating risk-taking as a result.

Federal deposit insurance tends to place the best capitalized institutions and the most conservative managers at a disadvantage when it comes to attracting funds. Once federal guarantees make the government's credit rating the relevant risk criterion for depositors, money will flow to the riskiest firms in the industry as individuals seek out the highest returns.

The S&L industry during the 1980s provided a dramatic demonstration of how federal guarantees can turn capital market norms on their heads. Federal deposit insurance tends to place the best capitalized institutions and the most conservative managers at a disadvantage when it comes to attracting funds. Once federal guarantees make the government's credit rating the relevant risk criterion for depositors, money will flow to the riskiest firms in the industry as individuals seek out the highest returns. In normally functioning capital markets, private capital and individual firms' risk-taking matter. In federally insured markets they do not.

Although the S&L industry of the past decade provided a worst-case scenario, the introduction of federal financial guarantees encourages insured institutions to economize on capital from the beginning. That in itself is a risk-enhancing move.

In the early 1900s, for example, banks' capital-to-asset ratios exceeded 20 percent, and double liability for stockholders of nationally chartered banks increased their effective capital cushions even further. Since the introduction of federal deposit insurance, however, banks' capital has declined to 7 percent or so, and many banks operate with even lower capital ratios. The trend toward deemphasizing capital undermines owner discipline and makes banks more vulnerable to economic shocks. Because losses incurred in the big Texas bank failures averaged about 10 cents on the dollar, with slightly higher capital ratios those banks might have withstood the oil shocks and survived.

The introduction of federal insurance guarantees would similarly encourage even greater risk-taking among insurance companies. Making consumers indifferent to insurance companies' capital would encourage insurers' clients, and hence insurers themselves, to emphasize returns over safety.

Finally, the presence of federal guarantees gives political decisionmakers the ability to protect favored firms and industries. In the absence of federal deposit insurance, there would have been no S&L crisis during the 1980s. Savings and loans with fixed-rate mortgages and short-term deposits would have adapted or failed during the 1970s or before as their depositors demanded safe havens for their funds. A large number of closures might have occurred, but the cost would have been substantially lower than the \$200 billion currently facing taxpayers.

Lesson 3. The S&L crisis was not a cops-and-robbers problem; it was a mishandled industry restructuring problem. When the government becomes committed to protecting and subsidizing a particular industry for "the social good," policymakers are often tempted to ignore and even override market signals about the continued utility of that industry. Such efforts are rarely successful. Forbearance was rationalized by the supposed disruption of closing hundreds of S&Ls. In the end they were closed anyway. For all the government's efforts, contraction of the industry has proceeded. In 1979 there were 4,500 S&Ls; in 1991 about 2,200 S&Ls remained, and 300 to 500 more were slated for closure. And housing money has not disappeared. In fact, in many ways the market for mortgages is more competitive today than it was in 1982.

Meanwhile, delaying tactics designed to protect industry members cost taxpayers and other financial market participants hundreds of billions of dollars. The U.S. banking industry is currently undergoing a restructuring process. The question remains whether policymakers will impede or facilitate that restructuring.

Conclusion

It is not at all clear that Washington decisionmakers have absorbed the proper lessons from the S&L debacle. Despite high hopes in early 1991 that Congress would pass needed banking law revisions, the Federal Deposit Insurance Corporation Improvement Act passed during Thanksgiving week addressed none of the structural issues affecting the banking industry's health. The 1991 legislation contained neither new investment powers nor new geographic freedoms for banks. Regulatory inflexibility thus remains a problem for the banking industry.

The 1991 legislation did take some tentative steps toward limiting federal deposit guarantees. The \$100,000 per account protection remains intact, but Congress placed new restrictions on both the FDIC and the Federal Reserve that were designed to increase somewhat the risk of loss account holders with deposits exceeding \$100,000 face. Unfortunately, the new law also provides sufficient escape clauses, so that the ultimate impact on market discipline will depend on regulators' predilections toward protecting large depositors or leaving them unprotected. Tougher capital standards will be only as effective as the examination process enforcing them.

The most important question is whether Congress will condone continued shrinkage of the banking industry rather than resist failures as policymakers did with S&Ls. Although analysts agree that there are insolvent banks still operating that should be closed, Congress did provide additional funding for the Bank Insurance Fund through the 1991 legislation, and the act's new capital standards do give regulators the power to assume control of critically undercapitalized banks—those with capital at 2 percent of assets or less. The long-term interest of the banking industry and taxpayers will be best served if regulators apply consistent closure standards across the board for all institutions. Thus, uninsured creditors would incur losses regardless of the size of the institu-

tion. Government decisionmakers should resist the temptation to apply political criteria to determine which critically undercapitalized banks should be provided with continued life support and which should be terminated.

As far as the insurance industry is concerned, the S&L debacle should give regulators and would-be regulators pause when they consider a narrow list of appropriate or safe assets. Similarly, proposals to introduce federal insurance guarantees should raise alarms for both taxpayers and well-capitalized, prudently managed insurance companies.

Government decisionmakers should resist the temptation to apply political criteria to determine which critically undercapitalized banks should be provided with continued life support and which should be terminated.

The S&L crisis of the 1980s cost this country dearly. It is difficult to imagine how many jobs might have been created or what legitimate new businesses might have received financial support with the funds squandered by insolvent S&Ls in their desperate bids for survival. We will have gained something worthwhile from the S&Ls, however, if we learn the lessons that help us avoid similar fiascoes in the future. It would be nice to get something for our \$200 billion.

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