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The Bears and Honey Pots:

The Savings and Loan Debacle

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The recent experiences of the savings and loan industry, with the mounting insolvencies and losses, are giving the world a first-hand example of how a financial system should not operate. A number of economic factors, combined with a series of regulatory errors, have contributed to the substantial difficulties encountered by savings and loan institutions during the last decade. At last count, the cost of the bailout to taxpayers is expected to exceed $200 billion (plus $300 billion interest), but if the current downturn in the economy and real estate markets worsens, this could increase significantly as now-solvent institutions are jeopardized.

The potential for disaster in the S&L industry has existed since its inception. Modern savings and loans, also known as thrifts, have roots going back to building societies, which pooled members' savings and provided mortgages. In the U.S., the first such organization was the Oxford Provident, formed in Pennsylvania in 1831. It accepted small deposits (which then, and even now, are discouraged by many commercial banks) and, when $500 accumulated in the fund, made a loan to the member willing to pay the highest interest rate. As the S&Ls evolved from these early building societies, they continued to serve the purpose of pooling depositors' savings for home mortgages. Indeed, until the early 1980s, they were prohibited from offering other types of services such as checking accounts or business and consumer loans. This lack of diversification left the S&Ls vulnerable to fluctuations in real estate values and in interest rates.

In addition to the limitation on the types of assets which could be held, diversification was also restricted by the bans on interstate banking placed both on commercial banks and S&Ls. In fact, many states did not allow banking institutions to open more than one branch. These restrictions were enacted to prevent domination of the banking industry by a few large institutions. The S&Ls were kept small and their mortgages were concentrated in the surrounding communities. The S&Ls' fortunes, then, were strongly dependent on local economic conditions.

S&Ls, like commercial banks, experienced severe difficulties during the Great Depression. Interest rate ceilings on commercial banks and federal deposit insurance were introduced in order to protect depositors, prevent bank runs, and stabilize the banking system. After some debate about whether deposit insurance would create a moral hazard (in which the existence of insurance could cause the insured to take greater risk), the FDIC was established in 1933 for commercial banks and the FSLIC in 1934 for S&Ls. The annual premiums were set for each banking institution as a percentage of its total deposits. The size of these funds was never adequate for dealing with large numbers of failures. Although the original goal was to have a reserve fund equal to 5% of deposits, it never actually exceeded 2%. The low premium rates, coupled with the growth in deposits and a series of increases in the maximum coverage to the current level of $100,000, led to reduced insurance coverage and increased taxpayer risk.

For a while, the deposit insurance system seemed to work. Bank runs were all but eliminated as insurance restored depositors' confidence. The S&L industry further improved as the post-World War II housing boom created a large demand for mortgages. In 1966, interest rate restrictions were also placed on S&Ls, but in order to allow them to aggressively compete for savings deposits, the limits were set 1/4% higher than the banks could offer. Still, trouble began to surface in the 1960s, when inflation nudged Treasury bill rates above those offered by banks and S&Ls, and funds began to leave the banking system.

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This process of disintermediation accelerated in the 1970s when inflation fueled by OPEC oil price increases pushed interest rates to record high levels. Many of the savers’ dollars flowed into the newly-formed money market mutual funds, which pooled the savings of small depositors and bought T-bills, large denomination CDs, and other money market instruments. Because they were not subject to interest rate ceilings, the money market mutual funds could offer higher yields.

Faced with a large loss in business, the S&Ls and banks successfully lobbied Congress for changes to allow them to compete. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982 introduced a number of changes in the banking industry. Interest rate ceilings were phased out and all depository institutions, including S&Ls, were allowed to offer money market deposit accounts and interest-bearing personal checking accounts called NOW accounts. S&Ls, which had been particularly hard hit by the interest rate increases due to their large mortgage holdings, were given expanded investment powers. Now they could diversify their portfolios by acquiring junk bonds and corporate equities, as well as consumer loans. In addition, minimum net worth requirements were lowered, so that the owners did not have to put up as much of their own money. Accounting standards were also loosened, causing some insolvent S&Ls to appear healthy.

Although the large interest rate increases in the 1970s had set the S&Ls difficulties in motion, the subsequent decreases in the early 1980s did not solve their problems. As the S&Ls moved into new, riskier ventures, they lacked both the knowledge and the caution to enter these activities. With essentially very little of their own money at risk, it was a gamble which, if it paid off, would benefit the stockholders, but if it lost, would be paid for by others. As one developer-turned-banker was quoted, “I am tired of playing Monopoly with my own money….. This way, we can use the depositors’ money.”

After a while, even the new creative accounting gimmicks could not disguise the massive insolvencies. The FSLIC, itself technically bankrupt, did not have enough funds to shut down the hundreds of insolvent S&Ls and to pay off the depositors. Instead, it began to look for merger solutions. Some of these were successful, such as the 1982 Citicorp takeover of Fidelity Savings of San Francisco. Through this and subsequent S&L purchases, Citicorp gained an exemption from national branching laws and, by the end of 1984, owned the sixth largest S&L group in the United States. Other mergers, however, were not so successful. With little money down and generous aid from the FSLIC, unscrupulous individuals were able to gain control of a number of S&Ls and convert them to their own personal piggy banks. Investigations by the FSLIC, the IRS, and the FBI have shown that billions were diverted from the S&Ls for private use. Government-insured deposits were used to finance lavish parties and trips, personal loans, excessive salaries and bonuses, private planes, and extravagant offices (and even a gold-plated toilet). Furthermore, fraudulent loans were made to friends and associates based on artificially inflated appraisals. Property could then be bought with no money down, and when the borrowers could not make the payments, the S&Ls would simply lend them more.

In theory, bank examiners should have uncovered and exposed such activities immediately. In practice, however, there were insufficient examiners to handle the growing number of problem S&Ls, and they were often underpaid and unqualified. Further, as Richard Pratt, chairman of the Federal Home Loan Bank Board from 1981-83, recently testified before the House Banking Committee, the Reagan administration tried to stop the Bank Board from seizing insolvent thrifts and the Office of Management and Budget cut supervisory staff. Requests for more examiners by Edwin Gray, chairman from 1983-87, were also denied.

The government is now belatedly engaged in an extensive investigation of S&L practices during this period of unrestrained operation. A three-year-old multi-agency task force in Dallas has filled 14,000 square feet of office and warehouse space with subpoenaed documents. Millions of pages of financial statements, loan applications, cancelled checks, and other material must be analyzed, making the process of finding enough evidence for an indictment for fraud extremely complex. So far, charges have been brought against seventy-seven people, with fifty-two convictions and only two acquittals. Increasingly, defendants are receiving prison terms, including a thirty-year sentence for the former head of the now-defunct Vernon Savings and Loan in Dallas. Even with convictions, it is expected that little of the tens of billions of dollars that have been lost in the S&L disaster will ever be recovered. Fines and restitution are rarely more than a few million dollars in any one case. Many of the S&L industry losses are sunk into failed mall and condominium projects and worthless junk bonds, so are essentially unrecoverable.

The effects of the S&L debacle go well beyond the massive losses to the taxpayers as a whole. The stability of many local...
the financial communities has been disrupted. The net outflow of funds from the S&Ls and the current crackdown on lending practices has caused a credit crunch in some areas, hurting legitimate borrowers for housing and other needs. Deposit insurance premiums, which had remained 8.33 cents per $100 of deposits from 1935 until last year’s increase to 12 cents, are slated for another jump to 19.5 cents in January 1991. This will reduce S&L and bank profits, causing losses to stockholders and perhaps even more failures. This increase in costs will also make it more difficult for U.S. institutions to compete internationally. In Japan, for instance, deposit insurance premiums are only 1 cent per $100.

A further effect is a massive regional redistribution of wealth, as most states will receive less in bailout money than they will pay in additional federal taxes. Professor Edward W. Hill of Cleveland State University has estimated that the bailout will redistribute wealth from thirty-seven states and the District of Columbia to the thirteen states where most of the failures occurred. Massachusetts is expected to be one of the biggest losers, with relatively few S&L insolvencies and relatively high income taxes. In addition, cuts in defense spending, spurred in part by the budgetary pressures of the bailout, will exacerbate its woes. Texas, on the other hand, is the largest net gainer, since it pays 7% of total federal taxes but is slated to receive 60% of the bailout funding. In effect, the system rewards those regions with the most fraud, corruption, and mismanagement. Recent oil price increases are likely to enlarge these regional inequities as the Northeast consumers lose and the Southwest producers gain.

Solutions to the S&L problem are now being developed and implemented. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, restructures the entire S&L industry. The long-dead FSLIC was finally put to rest and replaced by the Savings Association Insurance Fund, an agency of the FDIC.

Minimum capital standards have been increased and lax accounting principles tightened. The Resolution Trust Corporation (RTC) was created to oversee the liquidation of assets from insolvent S&Ls, including everything from mortgages to junk bonds to gold-plated toilets. The RTC was given $50 billion in initial funding last year, which is being used to operate seized S&Ls and to cover insured deposits when the thrifts are sold to new owners.

Still, a number of further changes must be made in order to restore stability to the financial system. The deposit insurance system needs to be reformed with an eye to giving depositors incentives to examine the safety of particular banking institutions, while at the same time limiting taxpayer liability in the event of losses. Treasury Undersecretary Robert Glauber recently stated that the $100,000 limit is unlikely to be lowered, but that he may recommend a limit on the total number of insured deposits an insured depositor may have. This method, known as a “haircut,” would provide the wealthy with a reason to investigate the financial condition of a savings and loan or bank, and not merely search the country for the highest possible yield. Another option would be to base a banking institution’s premiums on the riskiness of its assets and activities, just as a skydiver pays more for life insurance. Some have called for a repeal of deposit insurance altogether, but this radical move could lead to bank runs like those experienced in the U.S. before 1933. For instance, in 1985, there were runs on non-FSLIC insured institutions in Ohio, Maryland, and Rhode Island, when depositors became concerned that losses to the bank could exceed the state deposit insurance funds.

Much might be learned from the Danish banking system, which is considered to be one of the strongest in the world even though, until recently, it had no deposit insurance. (This was only introduced in 1988 in anticipation of European Commission.
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munity regulations.) Instead, the Danish government relies on an aggressive policy of examining bank soundness. All the bank’s assets are monitored and shown on the books at current market value, not historical value as in the U.S., so that losses are immediately reflected in the balance sheet. Portfolios are highly diversified and mortgages comprise only a small part of a bank’s assets. The government sets high net worth standards, and when these are not met, banks are promptly closed. In the rare event that there is not enough net worth to protect the depositors, the government steps in to do so at taxpayer expense.

Canada’s banking system has also proven to be much more stable than that of the U.S. Theirs is a more centralized system, with relatively few banks operating with a large number of branches. The Canadian government does provide deposit insurance, but payouts are relatively rare. (In fact, from 1923 to 1985 there were no bank failures at all in Canada, compared to 9,000 in the U.S. during 1930-33 alone.) Private monitoring of a bank’s financial condition by other banks helps to supplement regulators’ efforts and prevent potentially contagious bank runs. Like the Danish banks, Canadian banks engage in a much wider range of activities than do their U.S. counterparts.

The U.S., in fact, is the only major country without a true national banking system because of the existence of so many state and federal laws governing interstate banking and, except for Japan, is the only one that places substantial limits on the types of financial products and services that may be offered by banking institutions. It seems clear that in order to compete effectively both at home and abroad, the antiquated, crazy-quilt U.S. banking system must be overhauled. Prohibitions on branching and interstate banking should be lifted, enabling S&Ls and banks to diversify geographically and to reach a more efficient scale of operations. U.S. banks have been the world leaders in devising new financial products and should be given the freedom to further develop their expertise. The distinctions between banks and S&Ls will become increasingly blurred as all financial institutions become more diversified.

At the same time, more rigorous supervision of each institution’s balance sheet must be exercised in order to ensure the depositors’ safety. Minimum capital standards, based on current market valuations of assets, should be raised and strictly enforced. Although such supervision is costly, the gain of having a stable banking system would surely outweigh the expense. The justification for increased regulation can be summed up by this recent statement from one economist: “There are a lot of honey pots out there. As long as there are bears around, we need regulation.”

It is also crucial that Congress continue to fund the RTC budget, which is already running low. The Congressional Budget Office estimates that shutting down the bailout process for even three months would add at least $300 million (not counting interest) to the cost. As the experiences of the last decade have shown, failure to deal with the problem now can lead to far greater difficulties later on.

Taking steps to handle the crisis and institute reform would help limit present and future taxpayer liability. As the taxpayers’ blank check is removed, a measure of market discipline would be instilled in the system through monitoring by large depositors, stockholders, and banking institutions. Although the lessons learned from the savings and loan crisis are costly ones, perhaps they will result in a strengthening of the U.S. financial system in the years to come.