Savings and Loans Crisis

# Introduction:

Savings and Loans Crisis (S&L Crisis) in the late 1970s and early 1980s is a classic case of regulations being out of tune with market realities. It was the biggest financial crisis in the US Financial system since the Great Depression (1929-1933) and was in a way precursor of The Global Financial Crisis of 2008. Both S&L Crisis and The Global Financial Crisis had their roots in the residential real estate mortgage market. In this article, we will try to understand some of the intricacies of the S&L crisis viz. the key role players, the shortcomings in the regulations and The Garn-St. Germain Depository Institutions Act.

# Key Role Players from the inception to the demise of the S&L Market:

## US Congress & State Governments:

US Congress at the Federal Level was the chief law-making body for the S&L Industry. Prior to 1929-1933 (The Great Depression), there was little regulation for the S&L Industry or Financial Markets.

However, when Franklin D. Roosevelt became the US President in 1933 several legislations were enacted by the Congress for the Financial Markets. The second wave of legislations for the S&L Industry came in 1982 under President Ronald Reagan. This was followed by a third wave of regulations in 1989 under President George H.W. Bush.

The State Governments laws and regulations aped the ones enacted by the Federal Government and US Congress.

## Federal Home Loan Bank Board (FHLBB):

It was created under the “Federal Home Loan Bank Act, 1932” (FHLBA). Its responsibilities included supervision of the S&L industry and investigation of malpractices.

## Federal Savings and Loan Insurance Corporation (FSLIC):

It was established as part of the National Housing Act, 1934. Its job was to insure the deposits made in S&L Banks. FSLIC was regulated by FHLBB.

## S&L Industry:

The term is used to refer to the kind of banks that were dedicated to residential home loans. They started in 1830s as the commercial banks were not interested in giving loans for the purpose of home ownership. They were also popularly called as thrifts.

## Office of Thrift Supervision (OTS):

It was created in 1989 by the US Congress to replace the much maligned FHLBB. Its job was similar to FHLBB i.e. to regulate the S&L industry.

## Federal Deposit Insurance Corporation (FDIC):

It is the deposit insurer for the depositors in US commercial banks. After FSLIC was dissolved in 1989, the responsibility for the insurance of thrifts was transferred to FDIC.

## Resolution Trust Corporation (RTC):

RTC was a specialized agency set up under the provisions of the “Financial Institutions Reform, Recovery and Enforcement Act, 1989” (FIRREA). Its job was to close down the insolvent thrifts and resell their assets. After the RTC had discharged most of its responsibilities, its was wound up in 1995 and its responsibilities were transferred to FDIC.

## The Public (Savers and Borrowers):

The general public at large was also a key role player as their actions both created and responded to the market forces of the day. It is these market forces, which necessitated changes in the regulations and ultimately determined the fate of the S&L industry.

# Identification and Analysis of the shortfalls in the regulations:

Let us now systematically and sequentially analyze the shortfalls in the regulations that led to the demise of the S&L industry.

## Federal Home Loan Bank Act (FHLBA):

Formulated in 1973, FHLBA was the overarching Act covering the S&L industry. Created in a different era with different set of problems, the regulation failed to provide the requisite direction in 1970s and 1980s. FHLBA was faulty because:

1. FHLBA set a cap on interest rate the thrifts could pay to depositors. This rate was lower than the market rate.
2. FHLBA restricted thrifts to lend only in the home loan mortgage markets.

These restrictions had the following debilitating consequences:

Firstly, 1970s was an era of stagflation (low economic growth coupled with high inflation) and intense competition. Thus, thrifts began to lose both depositors and loan customers as both of them migrated to other kind of financial institutions which were not handicapped by such regulations.

Secondly, this regulation created an **Asset-Liability mismatch** in the thrifts balance sheet. While the deposits were made on short-term high interest rates, the loan book of thrifts comprised of long-term loans granted on low interest rates in an earlier benign interest-rate regime. Thus, **Net Interest Margin** (Interest received – Interest Paid – Admin Costs) for thrifts dwindled and even turned negative.

Thirdly, diversification of Loan Book is one of the key principles of Risk Management. However, thrifts **loan book was undiversified** and comprised of only home loans.

## Federal Home Loan Bank Board (FHLBB):

The regulations did not envisage FHLBB to be a strong independent body and was not adequately staffed. It overlooked several cases of malpractices and failed to recognize the incipient stress in the S&L industry due to stagflation and outmoded regulations.

## Federal Savings and Loan Insurance Corporation (FSLIC):

As per the regulations of FSLIC, the deposits of thrifts were under-insured. In 1983, $25 billion were needed to make good the losses of insolvent thrifts, but FSLIC had only $6 billion. Subsequently, FSLIC went insolvent in 1987.

## The Garn-St. Germain Depository Institutions Act, 1982:

The Act rectified many of the shortcomings of FHLBA, i.e. allowing thrifts to pay higher interests and to diversify their loan books. However, the Act did not specify any resolution of the zombie (already bankrupt) thrifts. In-fact the Act was misused by zombie thrifts to further magnifying their losses. They increasingly lent to risky sectors where they had no experience and paid ever higher interest rates to depositors just to stay afloat. Capital and LTV (Loan to Value) ratios were also loosened by the regulations which further fueled the go for broke reckless behavior.

This regulation had similar effect as Herbert Hoover’s policies following the Great Depression.

# Level of Regulation for The Garn-St. Germain Depository Institutions Act:

1. **Domestic:** It was a domestic act restricted in scope to US.
2. **Governmental:** It was enacted by US Congress and implemented by Government Agencies.
3. **Industry-Specific:** The Act was specific to the Home Loan industry and thrifts in particular.
4. **Direct:** The Act was direct in its intent and effect, and was directed at home loans, thrifts and banks granting home loans.

# Conclusion:

Thus, we may infer regulations are rarely absolutely wrong or right. What matters is appropriate regulation at the appropriate level of industry and time. FHLBA worked well for over 50 years but could not provide guidance to the S&L industry in the changed market scenario of 1970s and 1980s. The Garn-St. Germain Depository Institutions Act, 1982 was implemented at the wrong stage of the S&L industry. Finally, FIRREA was enacted in 1989 to bury the S&L industry once and for all. However, the story could have been different and much more pleasant had timely and well thought out action had been taken in late 1970s and early 1980s.

# References:

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