An Examination of Financial Instability in the Savings and Loan Industry of the United States in 1980s from a Minskyian Perspective

Rohan Arora (HE/14/67/029)

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Prof CP Chandrasekhar

Centre for Economic Studies and Planning

Jawaharlal Nehru University

Abstract

This paper aims to examine the literature on financial structures in place since the nineteenth century in the USA – in particular the Savings and Loan Industry – to bring out the basic aim and requirements of financial institutions and their role in modern economic growth. The paper tries to bring forth the fundamental questions that must be asked of any financial structure in place in order to determine its efficacy. Very specifically it seeks to ask and in a sense answer two particular questions:

A. Do financial structures spawn and evolve to serve the specific needs of an economy or does the economy wrap itself around the requirements of the financial structures in existence?

B. What kind of regulatory environment, if any, must be synthesized in order to best serve the single most important role of finance (in the author's opinion) – as a lubricant for driving equitable and real capital investment?

Introduction

The basic aim of human life is a relentless pursuit of fundamental principles. However, survival dictates that such onerous aims be actualized only after certain physiological needs are met. All material wealth comes from nature, and the sustenance of even the complex world economy of today is therefore ultimately dependent on nature.

In puritanical terms, finance can thus be considered as a system designed to congregate human labour on a scale proportional to what would be required to obtain a certain level of material wealth from exploitation of nature. The other basic role of finance is a dual of this – it also serves as the medium of distribution of claims over the material wealth so obtained between different economic entities. Combining this with the basic aim of human life: the basic aim of finance is thus to aggregate human labour effort in a manner to free people from the need to focus solely on their physiological survival; and distribute the material wealth (more or less) equitably so as to help everyone achieve that aim.

The aim of this paper is to conduct a well-meaning enquiry into the nature and development of financial institutions and relations over time. To this end a basic framework must be adopted, and a hypothesis must be selected. This paper is set in the basic framework of *Financial Instability* as demonstrated by Hyman Minsky (1977). To paraphrase, modern finance is a complex and sophisticated system of arranged transactions spread over time and with conditional triggers that makes indirect ownership of wealth possible (pp. 5-16). The following hypothesis is being examined:

Financial structures spawn to serve specific needs of aggregating sufficient and secured liquidity to complete creation of capital assets that stretch over a period of time. However, due to its dual nature of also dictating ownership over assets thus created, it eventually evolves to aid finance and hence financiers gain greater ownership rights over these assets. Therefore, a regulatory check must be maintained over the activities of finance to prevent outcomes that are negative for the economy as a whole.

The guinea pig to test out this hypothesis will be a scrutiny of the Savings and Loan Industry of United States, particularly post the 1982 wave of deregulation. The effect of the Glass Steagall provisions of the Banking Act of 1933 in providing the legal regulatory framework for the operation of such institutions in the United States will also be examined.

The paper is divided into five sections.

The first section tries to glean through the history of US financial institutional framework and also attempts to ascertain the general direction of evolution of these institutions.

The second section puts the activities of the S&L Industry into perspective of the standard Minsky framework as described above. This section will also take a look on the influence of the activities of other sectors of US finance and try to ascertain the motivations of those at the helm of these institutions.

The third section will assess the aftermath of the S&L crisis and critically evaluate how the gradual deregulation abetted these events.

The fourth section will go back and look at the ingredients that went into the making of the crisis and the justifications for the same.

The final section concludes the paper by returning to evaluation of how frenetically evolving financial instruments are ultimately decoupling finance from its foundations. The predictive value of the analysis is also expounded upon.

A History of the United States' Financial Framework

A glance through the history of financial operation reveals a very certain model of the workings of finance.

Production of real goods in the economy requires financing, and greater the gestation period of investments being undertaken, greater is the necessity of external funds that must be arranged by some entity, in eventuality from citizens or households. This is the behest for the entry of finance.

In the beginning, all endeavours are honest, at least on paper. Entrepreneurial initiative is incumbent on technological progress that for a while supports monopoly profits.[1] More often than not, however, when entrepreneurship bears fruit, finance receives its due plus social currency of being legitimate and acceptable.

The bane of financial structures is ultimately overreach of leverage or debt. Debt, being built into the system as the mechanism of acquiring assets and increasing consumption today for money tomorrow, needs trust, which comes from the outlay of aforementioned social currency. All financial innovations are thus nothing but ways of increasing debt, presumably to the benefit of capital asset production. In truth however, it becomes a vehicle of arranging greater ownership of existing capital assets at the behest of future capital assets, which have an inherent uncertainty of coming into the economy; by extension generating future streams of income as quasi-rents on production, and hence providing value in possession.

Once social currency is exhausted however, the Ponzi scheme or euphoria breaks down and the downturn of economic activity follows. According to Galbraith (1990, pp. 22), "The financial memory is brief, but subjective public attitudes can be more durable." When the state represents the interests of the general population, these subjective public attitudes provide the social currency for enacting regulatory laws that try to slow down the build-up of

[1] See discussion on Schumpeter: Minsky, Hyman, "The Evolution of Financial Institutions and The Performance of The Economy" (1985). *Hyman P. Minsky Archive. Paper 210*

such financial euphoria. The promise of riches is alluring, but the pain of being broke is sharper.

The working of any system that is constantly in a state of disequilibrium requires mechanisms of feedback that are faster than the intended output of the system in order to timely observe signs of the system going out of control. Since human comprehension of financial fraud is slow, financial regulation and supervision allows to slow down the financial workings – making overextension of debt observable. The negative feedback of mass hysteria acts as a credible threat and generally keeps things quasi-stable.

The foremost US financial institutions that resemble modern Anglo-Saxon structure were established from a combination of what the colonies envisaged as well as active participation of London financial houses and the Bank of England. Financial discipline over 'innovations' like notes against Tobacco production (colonies of Virginia, Maryland and Carolina) was tried through the experiment of First Bank of the United States. It was equally a response to curb unchartered banking activities. Colonies that needed credit to expand but were short cried foul of the financial rigour thus imposed and in 1810 the charter of the Bank was not renewed.

The War of 1812 necessitated large public borrowing; the legitimacy emanating from this was used by many to create undue leverage. This in turn provided legitimacy for the Second Bank of United States (BUS-II). The collapse of 1819 that followed as BUS-II exercised its regulatory efforts, even though blamed on this institution, is essentially a testimony to the financial instability hypothesis. By the time BUS-II tried to bring about a correction in the speculative boom (reflected as is often the case in sharply rising asset prices), it was too late. The stage was set for a precipitous fall.

Essentially similar functioning explains the episodes of 1837, Knickerbocker Crisis and the subsequent creation of the Federal Reserve System, the depression of

1929 which paved the way for greater regulatory controls through the Banking Act and the Glass-Stegall provisions of 1933, and so forth, till about the end of the tranquil US economic boom in 1960s.

The interesting thing to note is that financial crashes from this point on have been used to legitimise deregulation rather than maintain or increase control on financial activities. The increased frequency and size of financial instability has become acceptable on measures that were established to dampen violent business cycles if the system did go out of control: the automatic lender of last reserve function of the Federal Reserve, the increased size of deficit spending in economic downturns and insurance measures like the FDIC. This is a natural consequence: without negative regulatory feedback, security measures abet rather than impede financial fraud. The major difference now is that debt deflation has been replaced by a combination of periodic increase in inflation and unemployment rate.

A Historical Perspective of Housing Finance

Housing finance in any modern world economy is an indispensable indicator of its social orientation. Per Richard L. Florida (1986),

> “Housing finance provides telling insights into the political economy of any advanced industrial economy. It is integral to the performance of capital markets, reflective of the role of the state in the economy and illustrative of the priority placed on producing affordable housing.” (pp. 207)

The beginnings of housing finance in US lie in the thrift institutions that were brought to the colonies from the Old Western World by the settlers. These were essentially mutually co-operative credit institutions where the members subscribed to a share that paid dividends while the money so collected would be loaned out as mortgage for housing construction. The executive officers were from among the members themselves and often times it was the members who incurred the mortgages. Once the mortgages were paid for and the shares of members matured, the thrifts would often be dissolved.

Through a series of operative changes in the subscription of shares and calculating of dividends, the thrifts eventually became perpetual entities often times referred to as Buildings and Loans (B&L) or Co-operative Banks. The industry became somewhat organised with the enactment of laws regarding thrift institutions by various state. Even as many larger B&Ls became organisations with joint stock ownerships with activities designed for profitability, the roots of B&L largely stayed firm in its principles of community based savings institutions; with securing the American home at the vanguard of morals and values being the cornerstone of its philosophy.

The industry took its modern garb post the ‘nationals’ crises where the damages were largely private as there was no Federal Insurance. This crisis had attributes of over-leveraged debt – pushing the large for-profit national B&Ls into Ponzi finance with the crash occurring after a mass financial euphoria. (Rising real estate prices leading to higher appraisal values followed by major losses upon foreclosure).

The industry transformed during the 1930s when federal rules regarding the functioning of thrift institutions were laid out, the founding of FHLB, instituting of the Federal Housing Loan Insurance Corporation (FSLIC) and the standardization of thrift practices under the aegis of Mr Bogdam who was a heavy influence in the organisation of thrifts commonly called the ‘League’. It was during this period that the social nature of community thrift institutions morphed completely; and it became a standard practice to include the term “Savings and Loan” in the names of all thrift companies.

A reading through the modern history of S&Ls conforms very tightly with the Financial Instability Hypothesis. It is largely a story of the S&L industry profiting from increased construction demand for housing like during the post-World War II economic boom, followed by the competitive dividend rates of the 1960s that had to be supported with riskier loan making activities with higher risk of default (the speculative finance stage) followed by rising rate of defaults as the construction boom slowed down during the late 60s.

Historically, any major crisis in the S&L industry would lead to greater regulations; either through state or federal government acts until the 1930s or through pro- active vigilance of Federal Home Loan Bank Board during the fifties and the sixties (the inclusion of thrifts in Regulation Q by the Congress after the rate war between banks and thrifts is a case in point, although thrifts were allowed to offer .25% higher interest rates).

The interesting reversal happened after the sluggish growth of S&L in the years post the Interest Rate Control Act of 1966. Even as thrifts remain largely profitable, the number of thrifts declined during the 70s with increasing loan loss to reserve ratio for the industry. Incidentally this was also the period of financial innovations like NOW accounts: the beginning of the speculative episode in wake of the construction demand; the Vietnam War and the economic stimulus of deficit spending by government post the recession of 1960s. The reversal, however was that instead of stricter regulation of the industry, this stage was used as a scapegoat for aggressive deregulation.

To quote (Mason, 2004),

> "In 1980, the Depository Institutions Deregulation and Monetary Control Act initiated deregulation by relaxing controls on interest rates and depository services, while the Garn-St. Germain Depository Institutions Act of 1982 completed the process by expanding thrift lending powers." (pp. 213)

Although the speculative episode is an extension of accumulative human behaviour and in an economy with finance facilitating modern capital production comes to be largely built into the system; the deregulation drive that followed set the stage for quantitatively larger and more frequent indulgences in Ponzi finance. This ushered in an era of abuse of government trust measures (like FDIC), magnanimous financial frauds and perverse signalling through bailouts that protected the perpetrators of financial ruin rather than the public or taxpayer as was espoused to justify them.

The savings and loan crisis: aftermath and impact

In order to assess the impact of deregulation, it is necessary to paint a picture with numbers. During 1955-81, barring bank failures prevented by open-bank assistance, average failure rate was 5.3 per year. During 1982-90 failures averaged 131.4 per year: a factor increase of 25 compared to the earlier period. From 1987-90 failures averaged 187.3 per year. This period also witnessed the Black Monday, when Dow Jones fell 22.61%.

Between 1980 and 1989, a total of 890 S&Ls with $347.8 billion (US billion) in assets went out of business. The insolvencies in the early 1980s were smaller S&Ls with an average of $302 million in assets; the thrifts that failed after 1985 were much larger, with an average of $467 million in assets. By 1986, 255 thrifts with $68 billion in assets were RAP-insolvent. As the number of insolvent thrifts rose, the cost of assisting them also skyrocketed. After spending $800 million in 1984 to resolve failed thrifts, the FSLIC spent $7.4 billion in 1985 and $9.1 billion in 1986. As a result, the reserves of the thrift insurer, which were $6.2 billion in 1980, fell to less than $2 billion by the end of 1986.

In the aftermath of this catastrophe, the Bush administration in 1989 bailed out the industry. Besides the debt restructuring and burden sharing between the industry and government deficits, FHLBB and FSLIC were abolished, with FDIC acting as deposit insurer and regulatory oversight transferred to OTS: an agency within the Treasury. Capital reserve measures were tightened, and Creative Regulatory Accounting Principles were reigned in. Further, the Justice Department was granted 50 million USD to prosecute industry fraud. The total thrift industry declined by almost 50% to 1645 institutions. The bailout cost the taxpayers $210 billion and the industry another $50 billion (in 2009 prices).

The failures were most spectacular in the states of Texas, Florida and California, where the states had enacted highly favourable laws that allowed S&Ls to virtually invest 100% of their capital in any financial instruments and vigorously engage in secondary mortgage market; as a reaction to S&Ls converting to Federal charter post Garn-St. Germain Act.

The explanations cited for these events include slowing economic growth, the oil price crash in Texas, frenzied interest rate competition, the slowing pace of construction among others. The control fraud theory of William Black is highly instructive. Control Fraud theory states that in an environment conducive to large scale financial manipulation, those with a pathogenic tendency to engage in fraud will do so. Then there will also be reactive fraud whereby CEOs of failing companies would engage in fraud in order to prolong the backlash of high debt to income ratio in their corporations (what he termed reactive fraud). An argument for financial conservatism could also be made from the fact that all "high-fliers"[2] were in fact fraudulent. This theory aptly illustrates two important aspects of human behaviour:

A. Deregulation and lax supervision either by design or by circumstances will result in inefficient outcomes as in the face of celebratory status of being rich, market self-regulation will always be an enigma. Markets are not an objective entity: they are shaped by people, morals and society at large.

[2] The term indicates those financial entities that use high debt compared to its equity or cash reserve and show record profits through financial innovations. In fact, such high fliers are often treated with jubilation rather than caution, being hailed as have finally unearthed a hitherto unknown model of accelerated growth in profits, eventually overheating as debt commitments become unserviceable. Financial fraud is often observed in these corporations.

B. There are unquantifiable damages from fraud that can cause systemic failure and bad welfare outcomes including loss of quality of life (Stiglitz, 2003).

The key assessment here is not to find out trigger events for such financial crashes – which are currently always an exercise in imputing blame to anything conceivable but the totemic debacle of market failure – but to realise that Ponzi finance is inherent in the system as investors and businesses seek to secure their margins of safety all the while using debt to increase ownership of assets and the impact of these failures on eroding the asset value of otherwise solvent and intrinsically robust contributors to economy is a sufficient reason to contain these events.

The origins of the crisis and its justifications

The weakening of the financial regulations enacted post the Depression and (continually modified for stringency thereafter till about 1950s) began with an increased competition for liquidity (i.e. deposits) between depository institutions and securities. This competition in turn was sparked off due to the higher rates of interest available to both small and institutional investors, primarily due to the Federal Reserve's action of allowing interest rates on government securities to rise. (Post the 1951 Accord).

If one is of a Keynesian mindset, then it is easy to see that such high interest rates led to contraction of private demand and were accompanied by inflation[3] and unemployment. The 70s were the heydays of monetarism, however, and under Volcker's chairmanship Fed squeezed out inflation through periodically increasing interest rates and tighter money policies; all this while public and private deficits increased.

[3] . Inflation occurred due to weakening currency as high interest rates in unregulated off- shore markets were chased; besides rising costs due to the oil shock and rising prime costs in a slow market.

Other major factors that made the regulatory interventionist regime unsustainable were interregional competition: such as the “race to the bottom” between states and transnational jurisdiction to attract incorporation and deposits respectively by lax regulatory provisions. William Black would term this environment as “crimogenic.” Financial innovations in the securities business, e.g. money market mutual funds prompted banks to create innovations of their own that blurred the Chinese Wall created by the Glass-Stegall Act and undermined the spirit of the law. Fed’s rather generous interpretations of the provisions of the act laid the grounds for its repeated abuse and later repeal in 1999.

The DIDMCA Act introduced in 1980 provided for complete phase out of interest rate ceilings in six years while insurance on deposits was increased to $100,000. The Garn-St. Germain Act of 1982 provided for protection of thrift and other thrift- like depository institutions through Capital Assistance Plans and provisions to undertake Interstate and Interindustry mergers under emergency conditions.

In fact, institutions with large capital assets (above $500 million) were especially protected for. This is all well and good, but without direct supervision in a high interest rate market, speculative investment would and did increase and the provisions for protection ultimately backfired, causing the exchequer a multi-billion-dollar deficit.

The large-scale change in public perception from the acuities of Depression to its complete erasure from memory requires considerable social engineering or manufacturing of consent.[4] Financial markets operated for a long time on the underlying principles of trust in not only honouring of future contracts but in the hope that those at the helm would maintain considerable integrity. The transformation of the S&L industry from a tax protected promoter

[4] The term first described by Chomsky, Noam and Herman, Edward S.: Manufacturing Consent: The political Economy of Mass Media (1988), Pantheon Books.

of housing construction to one of seeking self-interest happened because the considerable profits of this industry allowed the bigshots to organize themselves in successful pressure groups and lobbyists that could effectively influence the government and also generate public approval. Ironically, the deregulation that allowed these institutions to function as virtual banks led to fierce interest rate competition and the eventual collapse.

The gradual evolution of financial relations

Hyman Minsky grounded his Financial Theory Hypothesis during a period when the Glass-Steagall Act was in full force. His argument of financial fragility being built into the system has stood the test of time. Finance – when it mediates between money and activity – leaves its residue in the system in terms of the passive income it thus earns for its activities.

At the origin of finance, income through interests was considered illicit in the religious doctrine of the Old Europe. The cultural shift that took place during the Renaissance and Reformation period that made such profiteering licit perhaps failed to envisage the burgeoning residue of finance that is felt today through the frenetic pace of modern financial innovations and technology aided transactions.

Often the innovations in banking and finance are necessary to increase its outreach and egalitarian availability, especially when linked with increased production and demand in an economy with idle capacity. Increasingly however, modern financial activity is less concerned with intermediating on the margins of safety and more with increasing the size of its residue. This increased residue is felt in the demand prices of assets as well as the securities based on these assets.

When these assets are monetized however, the fall in prices are precipitous and it is realised that the risk associated with underlying securities that was thought to have been traded away is indeed borne out. In an economy based on realisation of profits from production, there is always uncertainty associated with ex post outcomes.

Increased financial activity does not eliminate risks, it simply trades them away like a hot potato in the hope that someone else's hands get burnt. This in turn means that the duration from appearance of financial fragility to financial crash is shorter in the current economy.

In earlier periods, such financial instability would be controlled due to the large size of the government, acting as the ‘spender of last resort’ and the central bank infusing liquidity as the ‘lender of last resort’. The modern financial liberalisation led global economy does not have a global government or central bank to play these roles.

Failure in financial market has real consequences. The shrinking of government deficit would ultimately lead to deep depression in such failures. But of course, at least this would affect the balance sheets of households and capital businesses as much as he financial sector. The narrative is however, markedly different in the era of financial bailouts. It is considered necessary to cut deficit spending on increasing consumption and demand though welfare schemes but not on the bailout packages to institutions that have become too big to fail. An examination of the aggregate numbers of mortgage business post the bailout indicate the proclivity of these institutions to invest in government backed securities and debt rather than mortgage lending.

Post the S&L crisis, the Resolution Trust Corporation had the choice of either selling off foreclosed properties and deeply depressing market prices or keep the assets attached and incur maintenance costs. With the bailout from above rather than the bailout from below (whereby defaulting loans could be restructured as had been the case in the past), the execution of the former option meant that debtors lost their assets at a distress sale, paid for the taxes to bailout the industry and in a tight monetary policy environment, faced high interest rates on future loans all the while as wage rates declined with weakening of bargaining strength. The fact that Reagan administration did intervene to weaken trade unions also helps. It is after all necessary to curb systemic inflation.

Interestingly, it is argued mechanism whereby the be allocated efficiently to that high interest rates bring about a self-selection increased savings so obtained would automatically those borrowers who can best service the debt. The argument naturally breaks down on the imperfections of information in the market. However, the endogeneity of speculative finance as margins of safety are adjusted post experiences of periods of realised profit in the economy does not. Even such efficient allocation cannot surely be free of uncertainties of production.

The argument for regulation is therefore not based on a foundation of eliminating financial instability, but rather on the following fronts:

A. Ensuring that finance remains grounded fundamentally in its organic role of mediating between activity and money. The dual of course is preventing subsidising of creditors, renters and speculators in gaining greater control over capital assets in the economy.

B. Ensuring equitable distribution of the fruits of production: the material wealth.

C. Relative stability in price of capital assets which represent not only their sale component but also the future streams of income realisable from them.

D. Ensure that financial episodes are fewer in quantity and smaller in magnitude, thus preventing the scope of damage to the real economy caused by unnecessary erosion of productive asset values.

E. The emphasis to innovate is in production technology rather than financial frenzy.

F. In the event of modern social narrative of seeking self-interest rather than social welfare, absence of information parity will always be maintained through propaganda and influence over the people of the government. Socially optimum welfare is thus only achievable through interventionist policies.

The author is not an ideologue of idle theorising in conspiracy theories; such activities are best left to people with substantial proofs and for personal entertainment. However, the current world order in finance – backed by the increasing financial liberalization efforts grounded in a well-developed theory – seems too far out to be reined in by anything less than mass penury. Unless the most crucial assumptions of rational expectations become truly internalised and applicable in the society as a whole, the well-grounded neoclassical synthesis will remain a chimera causing pernicious results.

The most practicable course of action therefore is to-the-asset financing, whereby small capital and inventory needs and those with a naturally short term of maturity are financed with short term instruments while long term financing should be reserved for assets acquired and utilised in specialised production processes with long gestation periods and long-lived streams of capitalized income.

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