Savings and Loan Crisis

Key role players from the inception to the demise of the S&L market

In the 1980s, the financial sector suffered through a period of distress that was focused on the nation's savings and loan (S&L) industry. Inflation rates and interest rates both rose dramatically in the late 1970s and early 1980s. This produced two problems for S&Ls. First, the interest rates that they could pay on deposits were set by the federal government and were substantially below what could be earned elsewhere, leading savers to withdraw their funds. Second, S&Ls primarily made long-term fixed-rate mortgages. When interest rates rose, these mortgages lost a considerable amount of value, which essentially wiped out the S&L industry's net worth. Policymakers responded by passing the Depository Institutions Deregulation and Monetary Control Act of 1980. But federal regulators lacked sufficient resources to deal with losses that S&Ls were suffering. So instead they took steps to deregulate the industry in the hope that it could grow out of its problems. The industry's problems, though, grew even more severe. Ultimately, taxpayers were called upon to provide a bailout, and Congress was forced to act with significant reform legislation as the 1980s came to a close.

The relatively greater concentration of S&L lending in mortgages, coupled with a reliance on deposits with short maturities for their funding, made savings institutions especially vulnerable to increases in interest rates. As inflation accelerated and interest rates began to rise rapidly in the late 1970s, many S&Ls began to suffer extensive losses. The rates they had to pay to attract deposits rose sharply, but the amount they earned on long-term fixed-rate mortgages didn't change. Losses began to mount.

As inflation and interest rates began to decline in the early 1980s, S&Ls began to recover somewhat, but the basic problem was that regulators did not have the resources to resolve institutions that had become insolvent. For instance, in 1983 it was estimated that it would cost roughly $25 billion to pay off the insured depositors of failed institutions. But the thrifts' insurance fund, known as the FSLIC, had reserves of only $6 billion.

As a result, the regulatory response was one of forbearance – many insolvent thrifts were allowed to remain open, and their financial problems only worsened over time. They came to be known as "zombies." Moreover, capital standards were reduced both by legislation and by decisions taken by regulators. Federally chartered S&Ls were granted the authority to make new (and ultimately riskier) loans other than residential mortgages. A number of states also enacted similar or even more expansive rules for state-chartered thrifts. The limit on deposit insurance coverage was raised from $40,000 to $100,000, making it easier for even troubled or insolvent institutions to attract deposits to lend with.

Shortfalls of the regulation which affected the S&L market

The following are the major causes for losses that hurt the savings and loan business in the 1980s:

- Lack of net worth for many institutions as they entered the 1980s, and a wholly inadequate net worth regulation.
- Decline in the effectiveness of Regulation Q in preserving the spread between the cost of money and the rate of return on assets, basically stemming from inflation and the accompanying increase in market interest rates.
- Absence of an ability to vary the return on assets with increases in the rate of interest required to be paid for deposits.
- Increased competition on the deposit gathering and mortgage origination sides of the business, with a sudden burst of new technology making possible a whole new way of conducting financial institutions generally and the mortgage business specifically.
- Savings and Loans gained a wide range of new investment powers with the passage of the Depository Institutions Deregulation and Monetary Control Act and the Garn–St.Germain Depository Institutions Act. A number of states also passed legislation that similarly increased investment options. These introduced new risks and speculative opportunities which were difficult to administer. In many instances management lacked the ability or experience to evaluate them, or to administer large volumes of nonresidential construction loans.
- Fraud and insider transaction abuses from employees.
- A new type and generation of opportunistic savings and loan executives and owners – some of whom operated in a fraudulent manner – whose takeover of many institutions was facilitated by a change in FSLIC rules reducing the minimum number of stockholders of an insured association from 400 to one.
- Dereliction of duty on the part of the board of directors of some savings associations. This permitted management to make uncontrolled use of some new operating authority, while directors failed to control expenses and prohibit obvious conflict of interest situations.
- A virtual end of inflation in the American economy, together with overbuilding in multifamily, condominium type residences and in commercial real estate in many cities. In addition, real estate values collapsed in the energy states – Texas, Louisiana, and Oklahoma – particularly due to falling oil prices – and weakness occurred in the mining and agricultural sectors of the economy.
- Pressures felt by the management of many associations to restore net worth ratios. Anxious to improve earnings, they departed from their traditional lending practices into credits and markets involving higher risks, but with which they had little experience.
- Organizational structure and supervisory laws, adequate for policing and controlling the business in the protected environment of the 1960s and 1970s, resulted in fatal delays and indecision in the examination/supervision process in the 1980s.
- Federal and state examination and supervisory staffs insufficient in number, experience, or ability to deal with the new world of savings and loan operations.
- The inability or unwillingness of the Bank Board and its legal and supervisory staff to deal with problem institutions in a timely manner. Many institutions, which ultimately closed with big losses, were known problem cases for a year or more. Often, it appeared, political considerations delayed necessary supervisory action.

Argument for which level of regulation the second article describes the Garn-St.Germain Depository Institutions Act

The Garn-St.Germain Depository Institutions Act was a ‘Domestic Level Act’. The Garn–St.Germain Depository Institutions Act of 1982 authorized depositories to offer money market deposit accounts with no regulated interest rate ceiling. The high interest rates that prevailed in late 1980 and 1981 resulted in a withdrawal of deposits from depositories and their reinvestment in nonbanking money market mutual funds (MMMFs).

Regulation Q of the Monetary Control Act had prevented depositories from meeting the rate competition from the MMMFs. The removal of the Regulation Q rate ceiling under the Garn–St.Germain Act permitted depositories to raise their rates and compete effectively. This act also broadened the lending power of savings and loan associations

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