Where Deregulation Went Wrong

THE American savings and loan industry has achieved much, but over the past few years the industry has been best known for some of the spectacular failures which have been recorded, threatening the viability of the whole system. 400 institutions insured by the Federal Savings and Loan Insurance Corporation failed between 1980 and 1987, their assets totalling $130 billion. Many other institutions have been merged, and the total number of savings and loan associations fell from 4,613 in 1980 to 2,961 in 1987.

Much has been written about the causes of the failures, but generally there has been so much attention focused on the immediate problems that the basic causes have been overlooked. This book briefly, but comprehensively, describes recent developments in the savings and loan business, in particular the causes of the failures.

'Thrown into the jungle'

The authors are particularly well qualified to write the book. The principal author is Norman Strunk, who was chief executive officer of the United States League of Savings Institutions from 1952 to 1980, and subsequently, for six years, was secretary-general of the International Union. His collaborator was Professor Fred Case of the Graduate School of Management of the University of California at Los Angeles.

The book neatly summarises the problem in one paragraph:

"For a long time the savings and loan business was protected from competition, and given special advantages by the law makers. It was structured to be failure proof, and supervised with that objective. Then, in the name of 'deregulation', almost overnight the business was thrown into the jungle of open competition even though it was not equipped for it by background or temperament, the size of its net worth, or the nature or size of its supervisory and examination establishment."

The stage for the failures of the 1980s was set during the period of mounting inflation and rising interest rates in the late 1970s. The savings rates of savings and loans were deregulated, raising savings costs and causing operating losses as loans were at fixed rates. A contributory cause of the failures was that most associations were not permitted to make variable rate home loans.

The failures occurred in two ways. The first was because of "spread problems", that is, the cost of funds exceeding the earnings on assets. These failures generally occurred from 1981 to 1984. The second wave of failures occurred because of losses on the assets side of the balance sheet.

Strunk and Case identify deregulation as being the single most important factor that precipitated the wave of failures. Another factor was that supervision and regulation was ineffective. The people who had worked so hard to deregulate the savings and loan business had failed to realise that there was a basic conflict between deposit insurance and the deregulation of financial institutions, and that by its nature deregulation requires stronger, not weaker, supervision of the institutions being deregulated.

The authors present a detailed analysis of the causes of failures. These can be categorised as follows:

(a) Lack of net worth, and wholly inadequate net worth regulations. It should be noted here that the trade bodies gave little encouragement to the regulatory authorities in trying to establish more meaningful net worth requirements.

(b) The absence of an ability to vary the return on assets in line with the rate of interest required to be paid for deposits.

(c) A rapid increase in investment powers of associations, partly through state legislative enactments in a number of important and rapidly growing states. There was in effect competition to persuade institutions to adopt a state rather than federal charter, and institutions were naturally attracted by loose regulations.

'Supervision ineffective'

(d) Fraud and insider transaction abuses which were the principal cause for some 20% of recent savings and loan failures. This was associated with a new type and generation of opportunistic savings and loan executives and owners.

(e) Dereliction of duty on the part of the boards of directors of some savings associations.

Arguably, the American system

→ 40

←39

always had inherent in it the seeds of its own destruction. Federal deposit insurance has been in force since the 1930s, and this gives individuals a guarantee that they cannot lose money by investing in an insured institution. A regulatory environment which attempted artificially through Regulation Q to limit the rates of interest which savings associations, and, more importantly, competitors, could pay on deposits, together with a prohibition of variable rate loans, operated splendidly when interest rates were low and stable. But inevitably this broke down as interest rates rose in the late 1970s.

There is, however, some confusion on this point, with some in the savings and loan business blaming the ending of Regulation Q for the failures, whereas, of course, it was merely a symptom of the problem. As Strunk and Case recognise, the regulation was eliminated simply because it could not cope with inflation and accompanying high market interest rates. They make the perceptive observation that the industry became too dependent on Regulation Q, and as this was unravelled so the business had great difficulty adjusting to unregulated markets.

What was essential in the late 1970s, and what did not happen, was the freeing of savings and loan associations to make variable rate loans. While the trade bodies lobbied in favour of this, Congress was opposed, supported by the National Association of Home Builders and organised consumer groups.

The deregulation of the industry occurred in the early 1980s. Adjustable rate mortgages were generally permitted from April 1981. In September 1982 the Garn/St Germain Act gave savings and loans much wider powers. However, this was followed by action by State legislators to give even wider powers.

For example, in California many of the large associations had switched from state to federal charter because of dissatisfaction with some aspects of the regulatory framework in that state. In California, state regulated institutions may legally make political contributions to candidates for state offices, although not to those seeking federal offices. The consequence of the switch was therefore that an important source of political funding was cut off.

→42

Number of Savings and Loan Associations

Year	Federally Chartered	State Chartered		Total
		FSLIC-Insured	Non-Insured*	
1980	1,985	2,017	611	4,613
1981	1,907	1,872	513	4,292
1982	1,727	1,616	482	3,825
1983	1,553	1,487	462	3,502
1984	1,478	1,460	453	3,391
1985	1,419	1,525	253	3,197
1986	1,345	1,466	267	3,078
1987	1,269	1,379	313	2,961

*Includes the assets of institutions insured by state insuring agencies.

Number and Assets of Failed Institutions
(in millions of dollars)

Year	FSLIC-Insured S&L Associations		FDIC-Insured Banks			
			Commercial Banks		Savings Banks	
	Number	Assets	Number	Assets	Number	Assets
1980	11	1,457.6	10	236.0	—	—
1981	28	11,553.4	7	104.0	3	4,755.0
1982	74	20,202.9	34	2,020.0	8	9,612.0
1983	55	19,741.8	46	4,267.0	2	2,760.0
1984	27	6,000.4	79	42,761.0	1	515.0
1985	49	18,441.3	118	3,040.0	2	5,701.0
1986	85	31,620.5	138	6,992.0	—	—
1987	71	20,918.1	152	17,627.0	1	1,180.0
TOTALS	400	129,936.0	584	77,047.0	17	24,523.0

Source: FSLIC and FDIC.

←40

Another result was a substantial reduction of funds for maintaining California's supervisory department. Members of the state legislature and the supervisory department became interested in rebuilding the state savings and loan system, and accordingly legislation was enacted to provide for the complete deregulation of California's savings and loan associations. This made it advantageous for institutions to switch back to state charter. In the event this did not succeed, but, rather, many new associations were formed, and, subsequently, some of these have run into difficulty.

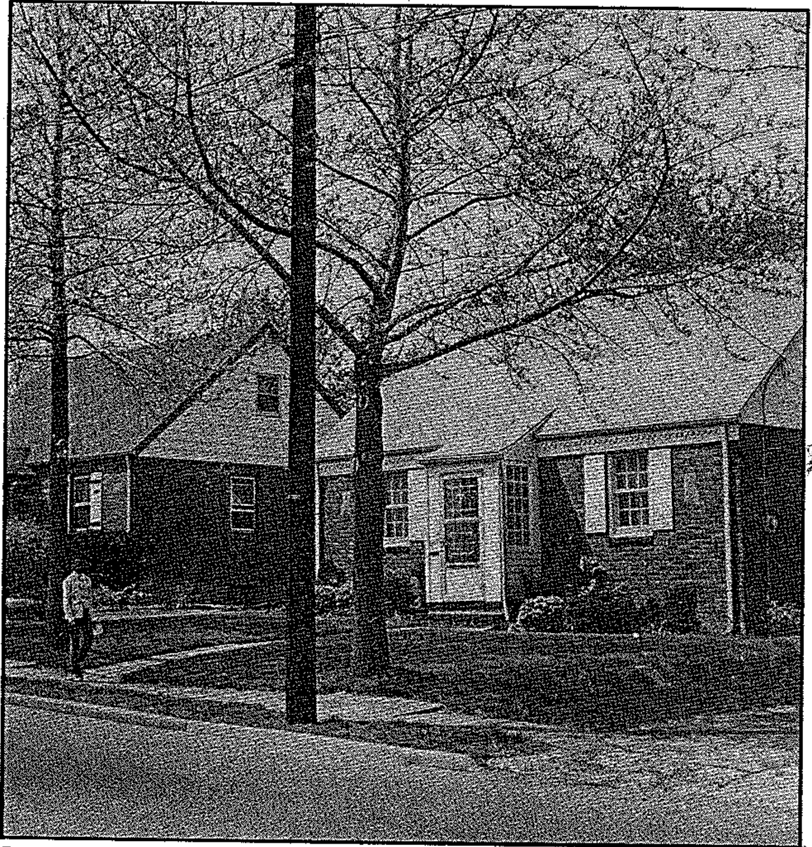
One interesting point to come from the book is that many of the failures have been associated with associations run by people new to the business. For example, of 72 associations

'Major problems inevitable'

placed in the management consignment programme (basically, having management imposed on them) from March 1985 until June 1987, about half were either managed or owned by interests new to the business since 1980.

The acquisition of small, existing state chartered institutions was actively promoted by groups of lawyers or consultants. They stressed that builders and developers could own an institution and continue operating a home building and land development business. Federally insured deposits could be used to fund the ventures. The old conflict of interest rules did not apply because the institution itself, not an individual or a company owned by an insider, was actually the builder-developer.

Strunk and Case cite one of the major causes of failures as inadequate supervision. The regulatory authorities over-estimated the ability of savings institution managers to respond to deregulation and to handle new powers, and generally there was a lack of appreciation of the need for adequate examinations, and supervisory and regulatory staff.



Deregulation has not made home ownership easier.

The book is very readable and manages to convey a vivid impression of what has gone wrong with the savings and loan business. In retrospect, of course, some of the problems should not have occurred, and someone looking at the American situation from another country would be little short of amazed at how one of the world's most sophisticated economies could so mess up the deregulation process.

It would certainly be obvious to a British commentator that borrowing short term deposits and making long term fixed interest rate loans was a recipe for disaster, and it should be equally obvious that combining federal deposit insurance with freedom of activity on the asset side of the balance sheet would be bound to lead to major problems.

Perhaps another book needs to be written on why the obvious points were not dealt with, and here one needs to look at the American political system. It may be that the regulators understood what needed to be done, or at least some of them did, but such is the great power of Congress, and in some cases even individual members of it, that eminently sensible steps which need to be taken can sometimes be delayed unreasonably. ■

Where Deregulation Went Wrong by Norman Strunk and Fred Case, United States League of Savings Institutions, 1988.