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## ...and Backward: Death and Transfiguration Among the Savings Associations

### Cover Page Footnote

The author thanks Dean John D. Feerick, Professor Michael M. Martin, Faculty Adviser to the Forham Law Review, and Professor Carl Fensfeld, Director of the Fordham Institute on Law and Financial Services, for their support and encouragement of the Graduate Colloquium. The author acknowledges the invaluable assistance of Mrs. Estelle Fabian, Assistant Director (Administration) of the Graduate Program and the Graduate Program staff, without whom nothing would ever happen.

# FOREWORD: . . . AND BACKWARD: DEATH AND TRANSFIGURATION AMONG THE SAVINGS ASSOCIATIONS

MICHAEL P. MALLOY\*

THE dramatic collapse of the thrift industry in the United States during the 1980s has been variously characterized as a “crisis”<sup>1</sup> a “debacle”<sup>2</sup> and a “disaster.”<sup>3</sup> In fact, it was—and indeed continues to be—a slow, suffocating death that is still playing itself out, “such a stuffy death,” as Yum Yum would say.<sup>4</sup> It is an event that has preoccupied U.S. regulatory policy towards depository institutions throughout the past decade.<sup>5</sup>

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1. Felsenfeld, *The Savings and Loan Crisis*, in Annual Survey of Financial Institutions and Regulation, The S&L Debacle: Death and Transfiguration, 59 Fordham L. Rev. S7, S8 (1991).

2. White, *The S&L Debacle*, in Annual Survey of Financial Institutions and Regulation, The S&L Debacle: Death and Transfiguration, 59 Fordham L. Rev. 557, 557 (1991).

3. Case, *Deregulation: Invitation to Disaster in the S&L Industry*, in Annual Survey of Financial Institutions and Regulation, The S&L Debacle: Death and Transfiguration, 59 Fordham L. Rev. S93, S93 (1991).

4. W.S. Gilbert & A. Sullivan, *The Mikado*, Act 2.

5. It may be argued that, in whole or in substantial part, the past four pieces of omnibus banking legislation enacted by the Congress have been devoted, perhaps futilely, to the resolution of the crisis in the thrift industry. See Depository Institutions Deregulation and Monetary Control Act (DIDAMCA), Pub. L. No. 96-221, 94 Stat. 132 (1980)(codified at scattered sections of 12 U.S.C.)(providing, *inter alia*, for expanded powers for thrift institutions and higher maximum deposit insurance limits); Garn-St Germain Depository Institutions Act of 1982 (DIA), Pub. L. No. 97-320, 96 Stat. 14 (1982)(codified at scattered sections of 12 U.S.C.)(providing, *inter alia*, for further expansion of powers of thrift institutions); Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987)(codified at scattered sections of 12 U.S.C.)(providing, *inter alia*, for the limiting and conditioning of powers of thrift institutions and holding companies thereof); Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989)(codified at scattered sections of *inter alia*, 12 & 15 U.S.C.)(providing for restructuring of federal regulation of thrift institutions and resolution of failing thrift institutions). On the DIDAMCA, see generally Weaver & O'Malley, *The Depository Institutions Deregulation and Monetary Control Act of 1980: An Overview*, 98 Banking L.J. 100 (1981). On the DIA, see generally Zaitoff & Mette, *Investment Powers of Federal Savings and Loan Associations after Garn-St Germain*, 36 U. Fla. L. Rev. 591 (1984); Aronowitz & Volk, *Developments in Banking Law: 1982*, 2 Ann. Rev. Banking L. 1 (1983); Norton, *The 1982 Banking Act and the Deregulation Scheme*, 38 Bus. Law. 1627 (1983). On the FIRREA, see generally Gail & Norton, *A Decade's Journey from "Deregulation" to "Supervisory Regulation": The Fi-*

The slow death of the thrift industry has prompted a number of responses from policymakers, ranging from shock and accusations to occasionally halting attempts at identifying the root causes of the crisis and fashioning constructive responses to the crisis. The most palpable result so far has been the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).<sup>6</sup> At this writing, it remains to be seen whether the FIRREA will bring about a positive transfiguration of the moribund thrift industry. Still, the task of the 1990-1991 Graduate Colloquium<sup>7</sup> was to examine the circumstances leading to the collapse of the industry and to speculate about what was likely to follow in the post-FIRREA era. The views expressed by the Colloquium participants, and reproduced in the pages that follow, provide useful and often provocative approaches to that task.

Professor Carl Felsenfeld initiated the Colloquium with a thorough analysis of the historical and regulatory background against which the crisis unfolded.<sup>8</sup> The picture that emerges from his analysis is that of an industry, and a group of regulators, that were to some extent trapped by their circumstances. Interim responses to an emerging crisis, each arguably reasonable in the context of its specific circumstances, ultimately proved inadequate as the crisis burgeoned.<sup>9</sup> Professor Felsenfeld gives explicit attention to what has often been an underlying but unstated question: does the death of the thrift industry presage a similar fate for commercial banks? His answer is that it does not,<sup>10</sup> but this conclusion is unlikely to appease the doomsayers among us.<sup>11</sup>

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*nancial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 Bus. Law. 1229 (1990); Gail & Norton, *The Financial Institutions Reform, Recovery, and Enforcement Act of 1989: Dealing with the Regulators*, 107 Banking L.J. 196 (1990); Malloy, *Nothing to Fear but FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation*, 50 Ohio St. L.J. 1117 (1989).

6. FIRREA, *supra* note 5.

7. The Graduate Colloquium is a facility established by the Graduate Program of the Fordham University School of Law for the examination of current legal issues in areas of particular interest to the Law School's LL.M. programs (*i.e.*, BANKING, CORPORATE & FINANCE LAW, AND INTERNATIONAL BUSINESS AND TRADE LAW). The Colloquium is a forum for periodic, formal presentations, throughout the academic year, by leading scholars, government officials, and recognized leaders in practice on cutting-edge issues in those areas. The theme for the 1990-1991 Colloquium series was *The S&L Crisis: Death and Transfiguration*.

8. See Felsenfeld, *supra* note 1.

9. See *id.* at S8-9.

10. See *id.* at S40.

11. When compared with the history of the S&L crisis, the current situation of the commercial banking industry may prompt a sense of *deja vu*. Consider, for example, the following observations from the executive summary of a recent Treasury report on the need for modernization of the U.S. financial system:

[T]he *competitiveness* of the banking industry has been undercut by our failure to adapt our banking laws to the evolution of financial markets, which has brought vigorous new competition to markets traditionally served by banks. . . . Having lost traditional customers to new competitors, banks have increased their concentration on remaining customer segments. Weaker banks with virtually unlimited access to federally guaranteed funds have chased too few lending

The Graduate Colloquium has tried to include an interdisciplinary dimension to the consideration of the problem of S&L industry. Professor Lawrence White, a noted economist and formerly a member of the now defunct Federal Home Loan Bank Board, offered a compelling analysis of the problem, focusing upon the distortion of accounting principles in the practices of the industry.<sup>12</sup> He urged the vindication of what we may call a truth-in-accounting approach as we emerge from the S&L debacle.<sup>13</sup>

Professor White's view was underscored in the Colloquium presentation by Mr. Richard C. Breeden, Chairman of the Securities and Exchange Commission and a principal architect of the FIRREA.<sup>14</sup> To the insights of economics, Mr. Breeden's presentation added a legal and policy dimension, and reached the conclusion that a fundamental realignment of federal policy was required, emphasizing the need for full and accurate public disclosure, in the regulation of depository institutions.<sup>15</sup>

The death of the industry is apparent. What, then, of its resurrection

opportunities, which has created problems for healthier banks: underpriced loans, narrowed spreads, eroded underwriting standards, and incentives to reach for riskier loans within the range of traditional bank activities. The result is diminished profitability, which has undercut the safety and soundness of the banking system.

[D]eposit insurance coverage has *expanded* well beyond its original purpose of protecting small unsophisticated depositors. . . . This overextension of deposit insurance has dramatically increased taxpayer exposure.

Overextended deposit insurance has removed *market discipline* that should have constrained the increased riskiness of weak banks. . . . [W]ith expanded federal insurance and no risk of loss, depositors have been more than willing to supply funds to weaker banks engaged in activities that produce inadequate returns and excessive risk. With so little to lose, these weak, undercapitalized banks have had a perverse incentive to take excessive risk—the "moral hazard" problem—exposing the taxpayer to even greater losses.

[B]ank regulation and supervision helps provide a substitute for the market discipline removed by deposit insurance. But in the face of the problems discussed above, our fragmented and archaic regulatory system has not been successful in stemming the weakening of the banking industry. In recent years, banks have experienced record loan losses and failures that are rapidly depleting the deposit insurance fund. . . .

[T]he *Bank Insurance Fund* . . . is at its lowest level in history as a percentage of insured deposits. It is projected to decline still further over the next two years. Without an infusion of funds, the Federal Deposit Insurance Corporation . . . could face the problems that plagued the Federal Savings and Loan Insurance Corporation—too little cash, too many incentives for forbearance, and possible exposure for the taxpayer.

U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (1991), reprinted in Fed. Banking L. Rep. (CCH) No. 1377, Part II (Feb. 14, 1991), at 9-10 (emphasis in original).

12. See White, *supra* note 2.

13. See *id.* at S69.

14. See Breeden, *Thumbs on the Scale: The Role that Accounting Practices Played in the Savings and Loan Crisis*, in Annual Survey of Financial Institutions and Regulation, The S&L Debacle: Death and Transfiguration, 59 Fordham L. Rev. S71 (1991).

15. See *id.* at S90-91.

and transfiguration? As I have noted elsewhere, the FIRREA identifies, even in its name,

the essential elements that stand in balance in the federal response to the crisis, and these elements are articulated in the explicit statutory purposes of FIRREA. At the center of this response is an effort to effect the recovery of the savings association sector [of the depository institutions industry], by "establish[ing] a new corporation, to be known as the Resolution Trust Corporation, to contain, manage and resolve failed savings associations" and by "provid[ing] funds from public and private sources to deal expeditiously with failed depository institutions." In addition, the act is intended "[t]o put the Federal deposit insurance funds on a sound financial footing."

However, FIRREA is not simply a "bailout" of failing depository institutions.<sup>16</sup> It is evident from the structure of the act that "recovery" is countered-balanced by a prospective concern with reform of the system of federal regulation of depository institutions, and particularly of savings institutions, "[t]o promote, through regulatory reform, a safe and stable system of affordable housing finance." Specific goals of regulatory reform in this regard are articulated by FIRREA. . . .

A final theme in the federal response to the thrift crisis concerns enforcement, a necessary aspect of any program aimed at the prospective reform of the depository institutions industry and the system of regulation applicable to it. Here the express statutory purposes are "[t]o strengthen the enforcement powers of Federal regulators of depository institutions" and "[t]o strengthen the civil sanctions and criminal penalties for defrauding or otherwise damaging depository institutions and their depositors."<sup>17</sup>

Has the FIRREA achieved, or is it likely to achieve, a transfiguration of the depository institutions industry through the application of recovery, reform and enforcement objectives? As is evident from the remaining presentations included in this Colloquium issue, the indications so far are decidedly mixed.

Professor Fred Case, coauthor of one of the most balanced analyses of the causes of the S&L crisis,<sup>18</sup> has raised serious doubts about the efficacy of the process of "recovery" established by the FIRREA.<sup>19</sup> He argues that the resolution procedures and policies adopted pursuant to FIRREA are impeding private market participation in the S&L recovery.<sup>20</sup> This is a significant concern, for, as Professor Lissa Lamkin Broome points out in her presentation,<sup>21</sup> private market solutions may

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16. White also disputes the popular conception of FIRREA as a "bailout" of failed savings associations. See White, *supra* note 2, at S61-62.

17. Malloy, *supra* note 5, at 1117-18 (footnotes omitted).

18. See N. Strunk & F. Case, *Where Deregulation Went Wrong: A Look at the Cause behind Savings and Loan Failures in the 1980s* (1988).

19. Case, *supra* note 3, at S104-05.

20. See *id.* at S105-06.

21. See Broome, *Private Market Solutions to the Savings and Loan Crisis: Bank Holding Company Acquisitions of Savings Associations*, in *Annual Survey of Financial Institu-*

provide an important element for achieving an effective transformation of the industry into a healthy and productive one.<sup>22</sup> FIRREA has at least provided the statutory basis for one such solution, the acquisition (and positive transfiguration) of savings associations by bank holding companies.<sup>23</sup>

The regulatory reform element in the federal response to the S&L crisis was touched upon by virtually all the Colloquium participants, and particularly by Professor Felsenfeld,<sup>24</sup> Professor White,<sup>25</sup> and Mr. Breeden.<sup>26</sup> An extremely important dimension from the perspective of state law and policy was added by the presentation of Ms. Jill Considine, then New York State Superintendent of Banks.<sup>27</sup> Ms. Considine provided a critical reaction to the Treasury report on the need for modernization of the U.S. financial system<sup>28</sup> that had just recently been released at the time of her presentation in February 1991.<sup>29</sup> Contrary to the federalizing trend in depository institutions regulation evident in the report, she emphasized the importance of the states' role in reform and improvement of the depository institutions industry.<sup>30</sup>

As to the enforcement aspect of the FIRREA, it is clear that the act embodies "a formidable array of expanded regulatory weapons against impermissible conduct on the part of depository institutions and institution-affiliated parties."<sup>31</sup> However, the question remains whether this aspect of the FIRREA program will be effective in contributing to a positive transformation of the industry.

In his Colloquium presentation, Professor Bruce Green has raised compelling arguments questioning the sense and sensibility of criminal penalty provisions of FIRREA and of the overall criminal law response to the S&L crisis.<sup>32</sup> In particular, Professor Green casts considerable doubt on the easy causal connection made, both by lawmakers and regulators, between "fraud" and the emergence of the S&L crisis.<sup>33</sup>

With respect to civil, or regulatory, enforcement responses to the crisis, Professor Lawrence Baxter has convincingly put into question the

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tions and Regulation, *The S&L Debacle: Death and Transfiguration*, 59 *Fordham L. Rev.* S111 (1991).

22. *See id.* at S112.

23. *See id.* at S145-46.

24. *See Felsenfeld, supra* note 1, at S49-56.

25. *See White, supra* note 2, at S69-70.

26. *See Breeden, supra* note 14, at S85-89.

27. *See Considine, A State's Response to United States Treasury Department Proposals to Modernize the Nation's Banking System*, in *Annual Survey of Financial Institutions and Regulation*, 59 *Fordham L. Rev.* S243 (1991).

28. *See supra* note 11.

29. *See Considine, supra* note 27, at S252-58.

30. *See id.* at S255-56.

31. Malloy, *supra* note 5, at 1152.

32. *See Green, After the Fall: The Criminal Law Enforcement Response to the S&L Crisis*, in *Annual Survey of Financial Institutions and Regulation, The S&L Debacle: Death and Transfiguration*, 59 *Fordham L. Rev.* S155 (1991).

33. *See id.* at S163-68.

likely effectiveness of the expanded enforcement powers of the depository institutions regulators.<sup>34</sup> Contrary to the received wisdom on the subject, he argues that courts may be unlikely to accord great deference to the enforcement activities of the regulators under FIRREA.<sup>35</sup>

As has so consistently been the case in the history of U.S. bank regulation,<sup>36</sup> regulatory reform efforts seem to materialize at the eleventh hour of crisis, or even later. Such has been the case with the S&L crisis and the transfiguration of depository institutions regulation that it prompted. In the current context, the response to the crisis may not have been sufficient or complete, and, as Professors Case, Green and Baxter suggest, the response may in fact be fundamentally flawed in one way or another. The progress of the effort for effective regulation of the depository institutions industry thus moves forward and backward according to the vagaries of history. It is hoped that the thoughtful contributions of the Colloquium participants will serve the positive purpose of focusing attention on important issues of regulatory reform and of moving future reform efforts in a forward direction.

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34. See Baxter, *Judicial Responses to the Recent Enforcement Activities of the Federal Banking Regulators*, in *Annual Survey of Financial Institutions and Regulation, The S&L Debacle: Death and Transfiguration*, 59 *Fordham L. Rev.* S193 (1991).

35. See *id.* at S194.

36. See, e.g., 1 M. Malloy, *The Corporate Law of Banks* 28 & n.1 (1988)(alluding to the "venerable tradition" in U.S. practice of initiating reform only in response to dire catastrophe).