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Fred E. Case

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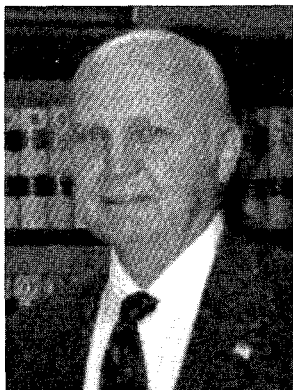


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DEREGULATION: INVITATION TO DISASTER IN THE S&L INDUSTRY

FRED E. CASE*

INTRODUCTION

In 1971 the Hunt Commission report set in motion a series of national legislative reforms that, by the early 1980s, culminated in almost complete deregulation of the savings and loan industry. The professed goal of deregulation was to encourage competition among financial institutions and to eliminate the savings and loan industry in favor of a new kind of financial system. Pursuant to the plan, only a few small specialized S&Ls were expected to survive.¹

Based on a disastrous mix of market realities and political and economic theories, deregulation was an invitation to disaster. Rather than streamlining the overburdened banking system, deregulation dismantled an effective home lending industry and produced a financial problem of disastrous proportions.²

The complete disaster is yet to unfold. Deregulation has created an infectious financial disease that may eliminate the home-mortgage lending industry and threaten other financial institutions as well.³ This unhappy outlook is premised on an evaluation of the reasons for "deregulation," and its associated problems, that Norman Strunk and I presented in a 1988 publication.⁴ This presentation is intended to expand

* This speech was given by Professor Case as part of the Annual Financial Institutions and Regulation Symposium at the Fordham University School of Law.

1. Cf. H.J. Cassidy, *The Role of the Savings and Loan Associations in the 1980s*, at 1, Speaker's presentation at the Third Annual Banking Conference: "The Changing Roles of Financial Institutions in the 1980s," Norfolk State University, Sept. 26, 1980 (available from author's files) ("Ever since the vision of the 1971 Hunt Commission of a single type of financial institution, with specialized institutions allowed but not specifically encouraged, there has arisen a thrust to achieve this vision.") [hereinafter H.J. Cassidy, *Banking Conference Presentation*]. Mr. Cassidy is the Director of the General Research Division of the Office of Policy and Economic Research of the Federal Home Loan Bank Board.

2. See Bernstein, *A Year Into the Bailout: The Future of S&Ls*, L.A. Times, Aug. 5, 1990, at D9, col. 1.

3. See Srodes, *Strange Silence in S&L Debate*, L.A. Times, Mar. 5, 1989, Part IV, at 3, col. 1.

4. Much of this presentation is a summary of a book Norman Strunk and I pub-

upon and better define the reasons we gave then for the disastrous consequences of deregulation.

First, the principal disaster of deregulation—the dismantling of an industry that was an effective source of home financing—will be examined. Next, the disastrous costs associated with deregulation's failure will be discussed. Finally, the failure of deregulatory theories and the remaining unresolved problems of deregulation will be outlined.

I. THE DISMANTLING OF AN EFFECTIVE HOME LENDING INDUSTRY

The harbinger of disaster was that deregulation was intended to fix something that wasn't broke. The regulated S&L industry, that deregulation was designed to dismantle, had already proven itself an effective source of home loan financing. The industry's shortcoming, that deregulation was supposed to cure, was a lack of competition.

The dismantling of the S&L industry began in earnest with the phasing out of Regulation Q early in 1980.⁵ With subsequent deregulatory measures the Federal Home Loan Bank Board ("FHLBB") expected that "[b]y 1986 an S&L [would] have to compete head-on with all other S&Ls, with commercial banks, with mutual savings banks, with credit unions, with money market funds, with corporate borrowers, and with the U. S. Treasury."⁶ In effect, the S&Ls would be thrown to the wolves. Only a few years earlier the S&L industry was dominated by neighborhood S&Ls that specialized in servicing local housing markets; they were only dimly aware of the levels of competition they would be facing.⁷ Deregulation had a "dismantling" effect because it was intended to eliminate S&Ls by collapsing their functions into large-scale generic financial organizations.⁸ This would prove disastrous because the traditional, regulated S&L industry was the most effective source of home financing.

A. *The Special Nature of Traditional S&Ls*

The disaster associated with folding the S&Ls into a generic financial system occurred because, in carrying out their mission of deregulation, the deregulators did not consider the "special" nature of the S&L industry.⁹

lished in 1988. See N. Strunk & F. Case, *Where Deregulation Went Wrong: A Look at the Causes Behind Savings and Loan Failures in the 1980s* (U.S. League of Savings Institutions, 1988).

5. See, e.g., M. Mayer, *The Greatest-Ever Bank Robbery* 92-93 (1990) (discussing the effects of the dismantling of Regulation Q).

6. See H.J. Cassidy, *Banking Conference Presentation*, *supra* note 1, at 1.

7. See *id.*

8. See Bacon, *Big Banks Would Get Vastly Broader Powers Under Treasury's Plan*, *Wall St. J.*, Feb. 6, 1991, at A1, col. 6.

9. See Lockwood, *Thrift Industry Passes its 170th Anniversary*, in 2 *Outlook of the Fed. Home Loan Bank Sys.*, No. 5, at 20-24 (Sept./Oct. 1986).

Traditionally, community interest, not personal interest, was the hallmark of local S&Ls.¹⁰ From the beginning, S&Ls were members of an industry that expected regulatory "guidance." This attitude did not change appreciably until deregulation began in earnest in the early 1980's.¹¹

The unique, community-based character of the S&L industry allowed it to perform an important home financing function that, consequently, contributed significantly to overall national economic development.¹² S&Ls have in the past funded up to 50% of existing single-family home sales and between 25% and 50% of annual new home construction and sales. Housing construction has accounted for approximately 3% to 6% annually of the GNP; when the economic multipliers associated with it are considered, the contribution is equal to 7% to 17% of GNP. (See Table 1).

Furthermore, in many years residential construction has had an important counter-cyclical effect.¹³ S&Ls were also an important force in implementing a national housing policy to provide affordable housing for all American families, and in supporting the programs of the Federal Housing Administration ("FHA") and Veterans Administration housing-benefit programs.¹⁴ The economic contributions of a specialized industry have thus been made in spite of, or, as I would see it, because of, the very local nature of the traditional S&Ls.

Regulation was essential to the survival of the traditional S&L. Thus, when the regulations that protected the conventional services were dismantled, so was the industry they protected. Thereafter, the needs the industry serviced would go unsatisfied and the vital economic contributions would be lost.

B. Regulation and the Traditional S&L Character

The nature of S&L regulation ensured that the associations specialized in local home lending. Loans were limited to a 50 mile lending radius and to single-family homes, and association directors were local business and community leaders. Most associations were federally chartered mutual associations, thus assuring some continuity of managers and direc-

10. See N. Strunk & F. Case, *supra* note 4, at 17; N. Strunk, *Reducing the Risks of Financial Crises: The Savings and Loan Story*, 1-2 (unpublished manuscript presented to the Conf. on Reducing the Risk of Econ. Crises, Nat'l Bureau of Econ. Res., Cambridge, Mass., Oct. 17, 1989).

11. See N. Strunk & F. Case, *supra* note 4, at 17-29.

12. See Wallace, *Home Ownership Drives the Thrift System*, in 2 Outlook of the Fed. Home Loan Bank Sys., No. 5, at 11 (Sept./Oct. 1986).

13. See D. Lessard & F. Modigliani, *Inflation and Residential Financing: Problems and Potential Solutions*, in Capital Markets and the Housing Sector: Perspectives on Financial Reform 217, 218 (R.M. Buckley, J.A. Tuccillo & K.E. Villani eds. 1977) [hereinafter *Capital Markets and the Housing Sector*].

14. See R.M Buckley, J.A. Tuccillo & K.E. Villani, *Overview*, in *Capital Markets and the Housing Sector*, *supra* note 13, at 15-21.

tors. State chartered associations were largely stock types but were subject to FHLBB regulation and review when they applied for savings account insurance. Broad ownership of stock was required, and no one stockholder could own more than 5% of an association's stock. By accepting this regulatory scheme, S&Ls received protection from competition.

Some of that protection from market rate competition was provided by Regulation Q. Savings accounts could be insured through the Federal Savings and Loan Insurance Corporation ("FSLIC"), and liquidity was provided through membership on the regional FHLBB. Thereafter, additional liquidity could be had through packaged mortgage sales to the secondary mortgage markets made by government-sponsored corporations, such as the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC").

As thus conceived, the traditional model of a regulated S&L industry flourished until exposed to the ravages of the market when the protective cover of regulation was lifted.

C. *Industry Changes Wrought by Deregulation*

Deregulation was seen as an opportunity for improving the overall national financial system because the traditional S & L industry was seen as "passe."¹⁵ The FHLBB's Office of Policy and Economic Research, speaking through its Director, Dale P. Riordan, stated that "[w]e [the FHLBB] see less need for regulation because there will be more market discipline. . . . The most important economic factor affecting mergers in the 1980s will be increased competition. . . . [T]here will be a significant shrinkage in the number of savings and loan associations in existence."¹⁶ The Director, speaking to the Arkansas Savings and Loan League, continued: "[Y]ou will see a common philosophy . . . of deregulation . . . that rejects the notion that the regulator ought to impose strict conditions just for the sake of protecting the few In summary, it seems clear that market discipline will replace the regulator in the 1980s."¹⁷

True to the word of its proponents, deregulation changed the approach of the S&L industry completely.¹⁸ By introducing the element of competition, or "market discipline," a premium was now placed on advancing the self-interests of the officers, stockholders and directors of S&Ls, and

15. See D.P. Riordan, *Deregulation and the Future of the Thrift Industry* 7, Sept. 8, 1980, presented at 63d Annual Convention, Arkansas Savings and Loan League, Sept. 8, 1980 (available from author's files). Mr. Riordan is the Director of the Office of Policy and Economic Research at the FHLBB.

16. *Id.* at 2, 9.

17. *Id.* at 3, 11.

18. See M. Mayer, *supra* note 5, at 60-62.

service to local housing markets became an issue of minor importance.¹⁹

With the removal of Regulation Y, one or only a few persons could now become major stockholders. As such, they could exert a dominant influence over all association operations. The new and vast array of non-residential lending that these newly-empowered actors were now permitted to engage in under the Garn-St Germain amendment of 1982, however, were well beyond the expertise of the traditional S&L managers and directors. Many were unaware of the disasters that lay ahead.

II. THE DISASTERS OF DEREGULATION

From the beginning, deregulation was a disaster for the traditional S&Ls because more time and resources were required to operate in a deregulated environment than were available to local associations or that were provided by Congress. Moreover, the generic, large-scale financial associations envisioned by the de-regulators have yet to emerge in any significant number. The traditional S&L functions, however, are still necessary, but must be performed in a different and more hostile, political and business environment. To compete, the S&Ls had to abandon their traditional functions in search of higher returns from high-risk ventures. Such ventures also fed the gambling urge of the newly powerful S&L owners.

Deregulation created a perfect environment for high-risk investors.²⁰ Because one or only a few individuals could own an association (in contrast to the traditional, broad community-based S&L directorship) they could engage in all kinds of real estate lending and investing projects. Single-family lending could be and was abandoned for all practical purposes. The historical safeguards—*i.e.*, regulations—that might have prevented such activities were no longer in place.

High-risk takers soon found, and exploited, a fatal flaw in the deregulatory scheme: The federally insured accounts of the typically local depositor (the traditional S&L customer) could be used to fund the lending and investment projects that the deregulated S&Ls were now free to pursue. The principal defect of deregulation, it now appears, was that it failed to introduce the true market discipline that it claimed as its guiding principle: While purportedly intended to introduce market discipline and competition to S&L industry, deregulation spared the S&Ls the market's rod of discipline—risk—and thus spoiled them. Coupling deregulation with insured accounts secured for the high-risk takers in the industry a steady flow of low-cost, risk-free funds for use in all kinds of real estate ventures, residential or otherwise. Because the new S&L own-

19. See, e.g., S. Pizzo, M. Fricker & P. Muolo, *Inside Job: The Looting of America's Savings and Loans* 156-176 (1989) (listing numerous examples).

20. See P. Zweig, *Belly Up: The Collapse of the Penn Square Bank* 81-89 (1985); see also M. Mayer, *supra* note 5, at 6-17 (describing way risk-loving investors could make easy profits in deregulated S&L industry).

ers were playing with insured funds they could not lose, and therefore had nothing to fear in the market that was supposed to discipline them.

Little attention, however, was paid to this inevitably dangerous and causal relationship between insured savings accounts and risky investing. Steady streams of new funds could be obtained locally and through brokers. Loans could be packaged and sold through secondary markets; securities could be created and sold; profits and interest "points" could be obtained through joint ventures and participation loans. Under deregulation many associations thus became money "milk cows" for venture-some real estate entrepreneurs.

As the costs of deregulation mounted, the availability of home loan financing decreased. At the same time, the costs of home ownership rose and the percentage of families who could afford a home declined. Much of this trend can be traced to the fact that deregulation did not eliminate the complexities and special requirements of an effective home lending process. The economies of specialization in the historic S&L industry were (presumably) traded for the expected, but undefined, economies of scale promised by generic financial institutions.

A. *The Disastrous Costs of Deregulation*

Little change was made to the S&L industry by deregulation, except for the dismantling of a functioning, efficient system of home financing. The costs associated with this change—the costs of liquidity, administration and fraud—however, were high and continue to mount.

The primary cause of these costs is the industry's liquidity problem. By accelerating the industry's liquidity problems, deregulation increased the administrative burden, and opened unusual opportunities for some in the industry, in the name of liquidity, to engage in fraud and other criminal activities. In particular, the Garn-St Germain bill opened the door to earning high rates on "unusual," non-residential investing and financing.²¹ The disaster of deregulation is that, ultimately, these costs will be borne by the taxpayers, who will be left without any effective source of home mortgage financing.

1. The Quest for and Cost of Liquidity

An S&L's fundamental task is to maintain sufficient liquidity to pay for daily operations and to take advantage of profitable investments. Borrowing—*i.e.*, collecting savings—is done on a short-term basis and lending is done on a long-term basis. A problem occurs for S&Ls when rate differentials—the cost of savings account deposits over the return on long-term home mortgage loans—are too often negative. The cyclical nature of real estate markets, increasing short-term interest rates and the

21. Cf. N. Strunk & F. Case, *supra* note 4, at 68-72 (discussing levels of various types of S&L investments).

long-term character of home mortgage loans are largely responsible for this profit-damaging effect.

The elimination of Regulation Q and subsequent court rulings on mortgage assumptions, however, only exacerbated this condition and helped widen the gap. S&Ls were left promising high interest rates to keep their deposits while holding mortgage portfolios with below-market yields. The associations could either sell their mortgages at a loss, or apply their available funds to high-yield, usually high-risk, investments. A liquidity crisis was inevitable.

Inflation and high interest rates in the late 1970s and early 1980s exacerbated the liquidity problems of the S&Ls. Deregulation compounded the problem by "overlooking" the undue influences of tax shelter laws, and overly optimistic forecasts of market trends in the late 1970s and early 1980s. In fact, deregulation was pushed in spite of the clear inflationary chaos of the real estate markets in such states as Arizona, Colorado, Florida and Texas. The lending freedoms given associations under deregulation, that they used in their search for solutions to their liquidity problems, naturally led the S&Ls to adopt "unusual" financing practices.

Under deregulation, the need for liquidity led to some "bizarre" approaches to attracting and keeping deposits and making loans. The use of brokered funds, partnerships in dubious projects, financing of joint-partnerships and loan participations in suspect commercial and industrial properties reflected a desperate attempt by the S&Ls to use the freedoms of deregulation to solve their liquidity problems.

Deregulation dealt with "illiquidity" by allowing the Resolution Trust Corporation ("RTC") to acquire the failing associations, sell their assets and apply the proceeds to their outstanding financial obligations, thereby eliminating the interests of stockholders. Inevitably, the RTC incurred regular losses, and it now owns associations burdened with billions of dollars in financial obligations to be paid for with assets of questionable worth.

The RTC's sales of S&L assets were expected to restore some liquidity, but to date this has not been accomplished. In 1988, when the crisis gained momentum, total S&L assets amounted to \$1.359 trillion. Mortgages held had book values of \$770 billion. (See Table 2). At that time, Norman Strunk and I, using a loss of asset-value approach, estimated that the costs of obtaining liquidity would equal \$30 to \$60 billion. Federal experts were estimating the cost at less than one-half of those amounts.²² Today, a cost of \$600 billion, an amount equal to 44% of the industry's total assets, is possible.

As of February 4, 1991, the Senate Banking Committee approved \$78 billion for the RTC to take over another 225 insolvent S&Ls.²³ The cost

22. See N. Strunk, *Deregulation and Savings and Loan Associations, U.S.A.*, at 3, May 11, 1989, presented at "XXVIIth Inter-American Housing Conference, Guatemala."

23. See Thomas, *Senate Banking Committee Approves \$78 Billion More for S&L Takeovers*, Wall St. J., Feb. 4, 1991, at A4, col. 5.

borne by the RTC to maintain these associations' liquidity seems immeasurable—it could easily approach \$1 trillion.

2. The Administrative Cost of Deregulation

Restoring the liquidity of the S&Ls is only one cost associated with deregulation; other costs include administering the deregulatory programs designed to ultimately achieve liquidity. As the RTC is now structured, the administrative costs promise to be consistently extravagant, and the process excruciatingly slow.

As recently as January 2, 1991, a report by a Presidentially appointed law firm concluded that “[f]ederal regulators mishandled the disposal of failed savings institutions in 1988 and likely added to the cost of the S&L bailout.”²⁴

The administrative problems facing the RTC are further complicated by a persistent lack of congressional support.²⁵ In 1991, housing construction, sales and prices are expected to decline, and the declining value of the real estate held by the RTC only increases the difficulty and cost of its disposal. Yet, in February, 1991, the House Banking Committee refused to pass a funding bill needed by the RTC to continue its asset sales, thus raising the prospect of even further losses due to administrative delay.²⁶

3. The Cost of Fraud

Any estimate of the costs of deregulation must include the extent to which fraud and other criminal activity has siphoned off unrecoverable funds. Fraud existed before deregulation, but only on a minor scale. According to FHLBB studies of the years from 1978 to 1985, of all cases of fraud and embezzlement it referred to the U. S. Department of Justice, 85% to 89% were from banks, 7% to 9% were from S&Ls, and the remainder were from credit unions.²⁷ These figures suggest that traditionally, fraud has occurred most often in banks but only to a minor extent in other financial institutions.

No one has yet presented an accurate estimate of the amount of fraud resulting from deregulation, but a good estimate might be 25% of the industry losses. More than coincidence was at work when levels of fraud increased markedly under the managerial “freedoms” associated with deregulation. One basic thesis of this presentation (and a forthcoming book) is that elements of organized crime took advantage of deregulation

24. See *New S&L Report Says Federal Regulators Mishandled Bailout*, Wall St. J., Jan. 2, 1991, at A8, col. 2.

25. See Thomas & Duke, *Bush S&L-Rescue Plan Is Sailing Along, But Congress Plans Some Major Changes*, Wall St. J., Mar. 10, 1989, at A4, col. 5.

26. See Thomas, *House Panel's Refusal to Clear Funds Could Result in Additional S & L Losses*, Wall St. J., Feb. 28, 1991, at A2, col. 5.

27. See *Editor's Note—Fraud Holds Steady*, in 2 Outlook of the Federal Home Loan Bank System, No. 5, inside front cover (Sept./Oct. 1986).

to steal hundreds of millions of dollars.²⁸ Much of the fraud was possible because it was supported by "bad" appraisals. Dubious—many fraudulent—appraisals of commercial, industrial and other non-residential properties were often accepted without question by S&L directors and loan officers, whose loan-appraisal expertise extended only to single-family loans.

III. WHY DEREGULATION FAILED

A. *The Failure of Accounting & Reporting Systems*

The failure of accounting and reporting systems impedes any accurate estimate of the losses and costs of deregulation. Those losses can never be estimated accurately without some improvement in the application of Generally Accepted Accounting Principles ("GAAP"), used by the industry's accountants and regulators, to S&Ls.²⁹

The deficiencies of GAAP are slowly being brought to light. The Wall Street Journal opined that "Congress let S&Ls get by with accounting practices that would have put the officers of less-favored businesses in jail."³⁰ All too frequently, an association's financial reports would be certified as conforming to GAAP, the association would be declared "healthy," and shortly thereafter regulators would declare the association "insolvent." Notably, the accounting firm of Ernst & Young recently agreed to pay the government more than \$40 million in connection with allegedly shoddy work.³¹

In the case of the Bell Savings and Loan Association (of San Mateo, California) GAAP only partially revealed the financial disarray that the association was in. Officers newly appointed by the FTC were faced with the task of understanding the full nature of the financial problems of the association, equipped with only inadequate or inappropriate data furnished according to GAAP.³² The reports simply did not provide appropriate managerial insights into the full nature of the existing financial problems of the association. Ironically, however, the GAAP method was useful to S&L managers in keeping the association operating despite continuing losses.

The major problem with GAAP is that it is not sufficiently sensitive to rapidly changing market events and new regulatory requirements. Yet, the dismantling of the S&Ls proceeded, supported by a steady flow of such reports that were also based on a variety of political and economic

28. See N. Strunk & F. Case, *supra* note 4, at 135.

29. See *id.* at 16; M. Mayer, *supra* note 5, at 7-13; *Cool It, Thrift Lobbyists*, Wall St. J., Feb. 6, 1991, at B3, col. 2.

30. *Ponzi Would Love It*, Wall St. J., Feb. 1, 1989, at A12, col. 1.

31. See *Ernst & Young Said to Set Pact With U.S. on S & L Job*, Wall St. J., Feb. 4, 1991, at A4, col. 2; N. Strunk & F. Case, *supra* note 4, at 75-78.

32. I was one of five directors appointed by the FHLBB of San Francisco to manage the insolvent association. The assignment was to be for ninety days; it lasted three years. Assets were reduced from \$1.2 billion to \$600 million.

theories supporting deregulation. Notwithstanding all of these errors in its implementation, the idea of deregulation itself was flawed.

B. *The Failure of Deregulatory Theories*

Deregulation was supported politically, in spite of the crumbling of the S&L industry and the high costs of implementing deregulatory policies, primarily because elected officials and FHLBB regulators saw deregulation as the most appropriate method of solving what they saw as an S&L industry crisis. Unfortunately, their actions were based on a disastrous mix of inappropriate, and poorly-presented and implemented, political and economic theories.

Deregulation fit well with President Reagan's notions of competition and free markets, and was sufficiently attractive, politically and theoretically, to attract the support of many elected officials, FHLBB officers and academic theoreticians. Moreover, as an operational program, deregulation was an easily invoked, mindless advocacy of an ill-defined but intuitively attractive goal. The potential disasters to be scored by deregulation, however, were never fully considered or anticipated.³³

1. The Theoretical Push

Much of the strong and constant theoretical and political support for deregulation came from FHLBB officers, particularly the appointed ones. Research support was provided in a constant flow of reports by the FHLBB research staff, who urged deregulation because it fit with the "free market" philosophy of using "market discipline" to provide more services for clients, eliminate redundancy, and increase long-run economic efficiency.³⁴

Deregulation was thus introduced largely because of its inherent appeal to those seeking to impose "free market" competition and less government. The results have become increasingly disastrous. The theorists have failed to flesh out their concepts and markets have changed, yet poorly informed politicians continue to find strong political appeal in supporting the deregulation concept.

2. FIRREA

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") was the first significant step towards improving the

33. See, e.g., Bryce Curry Seminar, Presentation by Preston Martin, *The Future Role of Thrift Institutions—Papers and Proceedings*, 45-47 (Apr. 9-10, 1987) (calling S&Ls "undervalued" and "a major growth opportunity").

34. See generally FHLBB Office of Policy and Economic Research, *The Savings and Loan Industry in the 1980s*, Research Working Paper No. 100, *passim* (2d ed. July, 1981) (discussing future role of S&L industry, the financial markets in which S&Ls operate, and deregulation's effect on S&Ls).

deregulatory program.³⁵ The Resolution Trust Corporation ("RTC") was created by FIRREA to deal with insolvent S&Ls; however, it has proven more costly and less effective than intended. Shrinkage of the numbers of solvent associations continues at an accelerating pace. Seized associations are managed at a survival level and the sales of their properties do not produce the kinds of funds expected, perhaps because of the "fire sale" mentality that prevails among regulators.

Thrift supervision was placed under the Treasury, but to date that has proven only moderately effective and questions are being raised about the condition of commercial banks. FIRREA placed all insured accounts under the supervision of the Federal Deposit Insurance Corporation ("FDIC") which still faces the same funding and inspection problems. On the plus side, FIRREA did require that S&Ls keep a greater percentage of their assets in home mortgages. In addition, loans to one borrower were restricted, land development projects were required to be placed in independent subsidiaries, capital requirements were increased, appraisal of portfolios was strengthened, and tax breaks were eliminated.

3. Where Free Market Theorists Failed

Notwithstanding the adoption of FIRREA, and the consideration of other legislation, the theories behind deregulation have failed to deal with a number of continuing issues. The following conditions reflect a failure of the theorists to flesh out their concepts:

1) A mortgage is still the same type of "difficult" instrument, and all the cyclical and cash flow problems associated with it remain unchanged. Mortgages still suffer constant value changes when valued on a market basis.

2) Savings associations were never in the money and securities markets and still are in no position to become involved on a professional, competitive basis. The world of options, futures and other sophisticated instruments is not within the regular expertise of S&L executives.

3) The nature of operations and competition in the industry has not changed. Entry into the industry remains costly, and is still limited by government. Rate competition does exist but only within bounds set by regulation.

4) Management of the traditional S&L function of home mortgage lending is still complex and calls for an array of supporting specialists, specialized mortgage instruments, escrows, property appraisals and even more complex approval and closing processes.

5) The information provided by GAAP or Generally Accepted Accounting Regulatory Principles ("GAARP") is little changed, and remains inadequate for the purposes of industry executives, regulatory supervisors, and private savers or investors. Private savers and borrow-

35. See generally M. Mayer, *supra* note 5, at 275-83 (informative discussion of FIRREA).

ers still do not have access to the kinds of financial information that would permit them to operate in an informed manner in a competitive S&L industry.

6) Competent, professional regulators and supervisors continue to be in short supply at a time when large financial institutions, that will require even more complex supervisory reviews, are emerging and being permitted to enter into new kinds of investments.

7) Despite the passage of FIRREA, the nation still lacks a fully articulated and implemented national housing policy. A critical element of such a policy must be recognition of the special requirements of home mortgage lending.

8) Finally, liquidity continues to be a major problem for the S&L industry.

C. *Political Failures*

The education of our elected officials about the savings and home financing industry was and is an important factor in obtaining deregulatory legislation. The S&L industry worked hard to bring its views to the attention of the elected officials. The United States League of Savings Institutions made many "educational" presentations to Congress and individual Congressmen in order to aid the politicians in understanding the S&L industry.³⁶ Unfortunately, Congressmen continued to appear poorly informed about, and at times almost indifferent to, the problems of the industry. Rather than seeking a balanced and better informed view, many elected officials found a great political payoff in supporting "deregulation," and responded to the S&L problem on that basis.

Deregulation was supported by the FHLBB with endless reports from an army of government and university academics who found great benefits and small losses in the process.³⁷ The United States League of Savings Institutions, which lobbied for S&L industry views, ultimately became a weakened voice for the industry.³⁸

The presentations of those who opposed deregulation were infrequent and not often listened to. As deregulation was implemented, a well-rounded understanding of the pros and cons of deregulation was woefully lacking. Key players in this process were the FHLBB Chairmen.

The FHLBB did little to enlighten the debates over deregulation because it quickly chose to advocate deregulation under the influence of its

36. See generally N. Strunk, *Memorandum Re: Misstatements of Fact and Emphasis With Respect to Problems of the Savings and Loan Business* (discussing the inaccurate handling of S&L issues by congressional committees) (available from author's files); *As S&L Crisis Grows, U.S. Savings League Loses Lobbying Clout*, Wall St. J., Mar. 7, 1989, at A1, col. 6.

37. The reports were prepared by a staff of academics through the FHLBB's Office of Policy and Economic Research.

38. See *As S & L Crisis Grows, U.S. Savings League Loses Lobbying Clout*, Wall St. J., Mar. 7, 1989, at A1, col. 6.

politically appointed chairmen. Although the S&L industry might have expected more objectivity and balance from the chairmen of the FHLBB, the deregulation concept was adopted first and most enthusiastically by FHLBB Chairman Preston Market, and was promoted in varying degrees by succeeding chairmen.

Nevertheless, some saw that an objective position by the chairmen, even the ability to implement many parts of deregulation, was practically a " 'Mission Impossible' ever since the Reagan ideas of deregulation were put into place in the savings and loan system."³⁹ Even when the chairmen tried to enforce some of the minimum elements of deregulation, they faced hostile business and political environments. With the S&L industry's advocates unable to speak effectively, and with the leadership of the FHLBB's chairmen in jeopardy, deregulation proceeded without a persuasive advocate for the S&Ls' role in supporting home ownership through home mortgage lending.⁴⁰

Further, those who presented theoretical support for deregulation so persuasively learned little from earlier "storm warnings." Large generic institutions, and deregulators who extolled the virtues of size, ignored the lessons learned in the case of the Penn Square Bank of Oklahoma City: Large financial institutions offer the same opportunities for failure and fraud as small ones.

IV. A CONTINUING NEED FOR REGULATION

Deregulation did not eliminate all regulation, nor did it reduce the costs and complexities of home mortgage lending, even though the S&Ls now have greater lending and investing freedom. Regulation of the types and amounts of loans to be made, liquidity reserves to be maintained, financial standards for entry, as well as provision for the supervision and examination of activities, and periodic reports of financial status, are still needed. These decisions should not be left to "market discipline."

Current experiences suggest that besides neglecting home mortgage lending (or, at best, failing to perform the function any better than the traditional S&L), large, generic financial institutions pose greater and more difficult regulatory review problems. One outstanding example is the Penn Square fiasco in Oklahoma City. Such chicanery is still possible, and on an even larger scale. Moreover, in a market composed of the large, competitive, generic financial institutions envisioned by deregulators, small savers and small home-mortgagors cannot compete with large corporate and government agency borrowers of the same institutions. Continued regulation is required to ensure that the need for home lending does not go unfulfilled.

Even if the large financial institutions envisioned by the deregulators

39. Letter, N. Strunk to F.R. Bleakely, Editor of *American Banker* (Dec. 6, 1989).

40. See Kuttner, *The Real Culprit in the Thrift Debacle: Deregulation*, *Bus. Week*, July 23, 1990, at 16, col. 2.

can be required (through regulation) to provide the same services to small borrowers now provided by the home financing industry, little has been gained by destroying that industry and recreating its functions in another kind of financial institution. Nothing is to be gained by replacing the so-called "duplicative" S&Ls with duplicative home-lending departments in large, generic financial institutions. Whatever its shortcomings, the traditional S&L is still the model best suited to perform the vital home-lending function.

Even if the proliferation of many small, local S&Ls is "duplicative," it is doubtful the home-lending mission can be performed as efficiently or as effectively by large, generic banking institutions. To date there is little evidence to support the deregulators' faith in such a system's ability to effectively service the home-lending market. Tremendous costs, however, have been incurred in this futile attempt to improve the home-lending industry, evidencing a need for a return to a traditional, regulated S&L industry.

CONCLUSION

The theorists and politicians who promoted deregulation failed to consider fully the consequences of deregulation to the savings and home financing industry. Emphasizing "free markets," they paid only slight attention to the many real problems still facing the S&L industry, and to those who sought a better consumer based, competitive, savings and home-loan industry that retained many of its traditional characteristics.

Given this disastrous mix of market realities and incompletely thought-through political and economic theories, deregulators must still address the following problems:

- 1) Developing a sound savings payment system.
- 2) Providing small, less sophisticated savers with risk-free investment and savings opportunities.
- 3) Assuring an appropriate allocation of national credit to the home financing industry.
- 4) Addressing and solving the cyclical nature of home financing.
- 5) Considering fully the consequences of eliminating the traditional S&L industry.
- 6) Creating a competitive financial institutional environment that will correct past mistakes by better understanding the realities of "market discipline."
- 7) Enlarging and making better use of the secondary mortgage markets.
- 8) Improving and supporting more profitable home lending opportunities.
- 9) Revealing fully the goals and priorities of those favoring free markets, competition and deregulation.

If deregulation had not been so ideologically driven and blind to mar-

ket realities and the special needs of the home financing and savings industry, it could have achieved more favorable results. As it was conceived and implemented, however, deregulation was and is a disaster.

TABLE 1
U.S. REAL ESTATE MARKETS (1960-1980)

Year	GNP (\$ bill.)	Current dollars (bill.)	Residential Investment (% GNP)			Private Non-Farm Residential Housing Starts (1,000 units)	
			Actual	Employment Multipliers		% change	
				Two	Three		
1960	515.3	26.3	5%	10%	15%	1252.2	—
1961	533.8	26.4	5%	10%	15%	1313.0	5%
1962	574.6	29.0	5%	10%	15%	1462.9	11%
1963	606.9	32.1	5%	11%	16%	1603.2	10%
1964	649.8	32.8	5%	10%	15%	1528.8	-5%
1965	705.1	33.1	5%	9%	14%	1472.8	-4%
1966	772.0	30.9	4%	8%	12%	1164.9	-21%
1967	816.4	31.1	4%	8%	11%	1291.6	11%
1968	892.7	37.7	4%	8%	13%	1507.6	17%
1969	963.9	41.2	4%	9%	13%	1466.8	-3%
1970	1015.5	40.5	4%	8%	12%	1433.6	-2%
1971	1102.7	55.1	5%	10%	15%	2052.2	43%
1972	1212.8	68.6	6%	11%	17%	2356.6	15%
1973	1359.3	73.3	5%	11%	16%	2045.3	-13%
1974	1472.8	64.8	4%	9%	13%	1337.7	-35%
1975	1990.5	62.3	3%	6%	9%	1160.4	-13%
1976	2249.7	81.1	4%	7%	11%	1537.5	32%
1977	2508.2	108.6	4%	9%	13%	1987.1	29%
1978	2732.0	129.2	5%	9%	14%	2020.3	2%
1979	3052.6	139.1	5%	9%	14%	1745.1	-14%
1980	3166.0	122.5	4%	8%	12%	1292.2	-26%
1981	3401.6	122.3	4%	7%	11%	1084.2	-16%
1982	3052.6	105.1	3%	7%	10%	1062.2	-2%
1983	3401.6	152.0	4%	9%	13%	1703.0	60%
1984	3774.7	179.1	5%	9%	14%	1749.5	3%
1985	3992.5	185.6	5%	9%	14%	1741.0	0%
1986	4231.6	217.3	5%	10%	15%	1812.0	4%
1987	4525.3	226.4	5%	10%	15%	1631.0	-10%
1988	4880.6	232.5	5%	10%	14%	1491.0	-9%
1989	5233.4	234.7	4%	9%	13%	1385.0	-7%
1990	5544.6	242.2	4%	9%	13%	1390.0	0%

SOURCES: U.S. Dep't of Commerce;
UCLA Forecasting Project, University of California, Los Angeles
(available from author's files).

TABLE 2
 FINANCIAL ASSETS AND MORTGAGES HELD BY S&LS
 (1965-1988)
 (BILLIONS OF DOLLARS)

Year	<u>Total Assets</u>		<u>Mortgages Held</u>		<u>Home Mortgages Outstanding</u>			
	Total	% change	Total	% change	% of Assets	% of Home Mortgages Outstanding	Total	% change
1965	126.3	—	108.1	—	86%	50%	218.3	—
1966	131.4	4%	113.2	5%	86%	49%	231.6	6%
1967	140.0	7%	119.5	6%	85%	49%	244.9	6%
1968	148.9	6%	128.4	7%	86%	49%	262.1	7%
1969	157.9	6%	137.9	7%	87%	49%	280.2	7%
1970	170.9	8%	147.3	7%	86%	50%	294.4	5%
1971	198.5	16%	169.2	15%	85%	53%	320.9	9%
1972	233.7	18%	200.0	18%	86%	56%	360.3	12%
1973	263.6	13%	227.1	14%	86%	56%	403.3	12%
1974	288.0	9%	246.1	8%	85%	56%	437.4	8%
1975	328.2	14%	273.5	11%	83%	57%	476.9	9%
1976	379.6	16%	316.2	16%	83%	59%	539.5	13%
1977	443.4	17%	371.3	17%	84%	59%	632.7	17%
1978	506.3	14%	422.1	14%	83%	57%	742.8	17%
1979	562.1	11%	466.1	10%	83%	54%	861.0	16%
1980	613.7	9%	494.4	6%	81%	52%	956.3	11%
1981	648.8	6%	512.2	4%	79%	50%	1,033.4	8%
1982	697.6	8%	482.2	-6%	69%	45%	1,079.8	4%
1983	818.9	17%	529.4	10%	65%	44%	1,200.2	11%
1984	977.0	19%	606.8	15%	62%	45%	1,336.2	11%
1985	1,058.3	8%	654.6	8%	62%	44%	1,490.2	12%
1986	1,140.6	8%	665.3	2%	58%	39%	1,720.8	15%
1987	1,247.0	9%	711.5	7%	57%	37%	1,943.1	13%
1988	1,359.9	9%	770.0	8%	57%	35%	2,174.2	12%

SOURCE: Flow of Funds Accounts, Financial Assets and Liabilities, Year-end (1963-1986)

Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (available from author's files).

