Savings and Loan Crisis

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INTRODUCTION

WHEN the federal savings and loan system was created in 1933, the United States was three years into the worst depression in its history. Industry was tottering, banks were closing by the thousands, unemployment was widespread and hunger was common. One key problem was the general failure of the housing market: people were losing their homes and were unable to buy new ones. The reasons for this condition obviously related to the depression. A population without money or jobs cannot pay for its housing.

Before the 1930s, a widespread group of financial institutions, generally termed savings and loan associations, or building and loan associations, were the principal financiers of home mortgages in the United States. These institutions were created, and were usually licensed and supervised, under state law. The mortgages generally had three to five year terms. They were also usually non-amortizing, so they had to be paid or, more typically, refinanced upon their oft-arising maturities. In the absence of consumer financial strength, the former was impossible and the latter bad business.

To meet this crisis, Congress created a large federal structure. One part, by no means the most significant at the start, was the federal sav-
ings and loan system. That system experienced immediate success and burgeoned over the course of some 45 years. Then it collapsed and has become the dominant financial disaster of our—and perhaps any—time. This Article will review that story. Part I describes the beginnings of the American S&L system. Part II traces the S&Ls' growth and success after the depression. Part III examines the beginnings of the thrift crisis in order to understand how and why it began. Part IV deals with the specific reasons usually given for the collapse of the system. Part V attempts to separate the reasons into those that were truly responsible for the disaster and those that affected the S&Ls only because of some factor intrinsic to the S&L system and that the S&Ls might well have weathered had they been better structured. Part VI considers the remedies that Congress has created to meet the thrift problem, both today and into the future, and questions whether the remedies are appropriate to the problem. Last is a brief and, to the author, unanticipated Conclusion.

I. THE BEGINNINGS

At the start of the depression, the state-chartered S&Ls (there being no federally chartered ones) owed about $500 million in short term obligations to the failing commercial banking system. When the banks called the loans, they thereby reduced the liquidity of the S&Ls, and, consequently, the S&Ls' ability to lend and refinance.5

The New Deal administration proposed,6 and the Congress enacted, a massive federal system to regenerate the housing market. Principal among the new depression-stimulated measures were:7

1. The Home Loan Bank system, created in 1932,8 to provide liquidity for the state savings and loan system and also, albeit secondarily, to arrange direct loans to consumer borrowers for home ownership purposes.

2. The Home Owners' Loan Corporation established in 19339 principally to refinance existing home mortgages that were in default or in need

5. See H. Russell, Savings and Loan Associations 31 (2d ed. 1960) ("This was one of the chief reasons for establishing the Federal Home Loan Bank System in 1932.").

6. Franklin D. Roosevelt's 1933 Message to the Congress, reported at 77 Cong. Rec. 1618 (1933) [hereinafter "Message to Congress"], declared a national policy to protect small-home owners from foreclosure and also relieve them from excessive interest. It proposed legislation to follow the general lines of the farm mortgage refinancing bill. The message was particularly concerned with protecting loans in existence, not with the making of new loans.


9. The Home Owners' Loan Corporation was the primary purpose of the Home Owners' Loan Act of 1933. See ch. 64, 48 Stat. 128 (1933) (codified as amended at 12 U.S.C. §§ 1461-1464) [hereinafter "HOLA"]). The Corporation was created by Section 4 of HOLA and was dissolved by the Housing Amendments of 1953. See 67 Stat. 121, 126, ch. 170, § 21 (1953).
of financial support. 10

3. The federal system of savings and loan associations, 11 created as a secondary purpose of the Home Owners Loan Act. 12

4. The Federal Savings and Loan Insurance Corporation, created and made a part of the Federal Home Loan Bank Board in 1934, 13 and designed to insure accounts in federal S&Ls and in qualifying state institutions. 14

5. The Federal Housing Administration created in 1934 to finance improvements on real estate, to buy and sell mortgages and to insure mortgages based upon its operations. 15

6. The Reconstruction Finance Corporation, actually created in 1929 during the Hoover administration. 16 Although its initial primary function was to provide capital for railroads and industry, it soon loaned money to the state savings and loan system. 17

These provisions are only part of a much larger plan whose underlying tenet was that the free enterprise system had been found wanting and that governmental intervention was necessary to sustain the economy. The philosophical and economic implications of that idea are beyond the scope of this Article. We will see, however, that the story of the S&Ls illustrates the principle that well-conceived governmental planning, when it contradicts the needs of a free market, results in loss. We will approach (but hardly resolve) this quandary in the concluding part of this Article.

Most of this Article is devoted to the federal savings and loan system (item 3 in the above list). It was created because the state system had become too weak and because the Federal Home Loan Banks, which had the legal authority to lend to individual home owners, lacked the machinery to make such loans. The state savings and loan associations were spread nationally and their principal business function had been the making of individual mortgage loans. The power previously accorded the Home Loan Banks to make such loans was withdrawn simultane-

10. See 77 Cong. Rec. 5586 (1933).
11. The federal S&L system was created by Section 5 of HOLA, supra note 9, 48 Stat. at 132 (1933).
12. See H. Russell, supra note 5, at 71. Mr. Russell, one of the authors of the Home Owners Loan Act, observed that the center of attention in 1933 was on the Home Owners Loan Corporation, not the creation of federal S&Ls. See id.; see also Message to Congress, supra note 6 (President's 1933 Message to the Congress asking for legislation to protect small home owners).
17. See H. Russell, supra note 5, at 40, 45.
ously with the creation of the federal S&L system.  

The federal S&L system was essentially restricted to making loans on the security of first mortgages on their borrowers' homes. The original Home Owners Loan Act provided as a limitation on the powers of federal S&Ls that "[s]uch associations shall lend their funds only on the security . . . of first liens on homes or [a] combination of homes and business property."  

Even this limited power was conditioned upon the property being within fifty miles of the association's home office and the loan not exceeding $20,000.

The short-term, three to five-year home mortgage that was typical in the years preceding the depression also ended with the creation of the federal S&L system. While longer term mortgages were not mandated either by statute or regulation, the regulations of the newly created Federal Home Loan Bank Board required that all home mortgages be on the "direct reduction plan"—the loans would be amortized over their originally scheduled terms. To allow for any sort of reasonable amortization schedule, loans had to have at least ten-year terms but were typically longer. The requirement that loans be fully amortized was eliminated when the Bank Board and its regulations were fully reorganized in 1949.

The long-term, fully amortized loan, made mandatory for federal S&Ls, was naturally more popular with borrowers than the earlier, short-term version. It was adopted by state S&Ls as well and has been the industry model ever since.

The state system of savings and loan associations was essentially the same as the federal system. Although subject to many different legal underpinnings, virtually all of the state institutions were soon insured and remained insured by the FSLIC. The federal insurer had to approve many details of their operations before insurance would be granted. Their pattern of operation and their corporate powers have traditionally been close to those of the federal associations.

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18. Section 4(d) of the Home Loan Bank Act was repealed in 1933. See 77 Cong. Rec. 4974 (1933).
19. 48 Stat. 128, 132 (1933). The associations were also permitted to lend on the security of their own shares, an insignificant power to which we shall not return, and also to invest in obligations of the United States or of a Federal Home Loan Bank.
20. See id. Another exception from the underlying restriction was that not more than 15% of an association's assets could be loaned without regard for the 50-mile limit or the $20,000 amount; the first mortgage requirement remained. See id.
21. See supra note 4 and accompanying text.
22. See 24 C.F.R. § 203.10(a) (1938).
23. See 13 Fed. Reg. 6949 (1949). Loans that were not fully amortized were at that time permitted. See 24 C.F.R. § 143.10(a)(1)(c) (1949). The term "installment loan" was created to refer to fully amortized loans. See 24 C.F.R. § 143.10(a)(6) (1949).
24. In 1982, only 1.8% of the assets in the S&L system belonged to institutions insured by state funds and not the FSLIC. See A.S. Carron, The Plight of the Thrift Institutions 3 (1982).
The S&Ls were thus frozen by both statute and regulation to a one-product business. Not only were these lending institutions denied the opportunity to hedge their risks and participate in the benefits normally associated with diversification and traditional "portfolio theory," but that single risk had two peculiarly dangerous ingredients: it was fixed in rate and long in term. Almost from its inception, it was subject to an underlying assumption. Each time an S&L put a real estate mortgage on its books it was betting that in the next ten to twenty years it would not have to pay more for its money than it was earning on that asset. If the reverse became true, the S&L ran a real risk of failure.

The country's commercial banking system had a markedly different attitude towards the real estate mortgage. In contrast to thrift institutions, banks generally had a much broader charter to engage in financial transactions. Under the National Bank Act—enacted in 1863—national banks were authorized to wield "all such incidental powers as shall be necessary to carry on the business of banking." State laws were comparable. Given these broad powers, commercial banks stayed away, for the most part, from the fixed-rate, long-term consumer real estate mortgage until the 1980s. The banks perceived themselves as the providers of short-term credit. It was commented that

[i]he reason why [commercial] banks do not lend on real estate is because they are afraid of frozen paper . . . . The banks have such a liquidity complex that they will invest their funds in United States Treasury bills at a fraction of 1 per cent, rather than to [sic] buy 10 year government bonds at 5 per cent. They simply will not take long-term paper and home mortgages are without any question long-term paper.

This perception probably saved the banks from the disaster ultimately experienced by the S&Ls. It is difficult to determine at this distance whether the significance of the assumption underlying the business of the federal (and through the federal the state) S&Ls was appreciated by those who, in their zeal to create affordable housing, created the system. Some signs can be found that the risks deriving from the assumption were appreciated, but were only an occasional thought rather than a cen-

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28. For example, the New York State Banking Law contains language almost identical to that in the National Bank Act. See N.Y. Banking Law § 96 (McKinney 1990).

29. H. Russell, supra note 5, at 94; see also id. at 96 (noting that the same self-imposed restriction held true for the non-bank finance companies).

30. See supra notes 10-12 and accompanying text. We remind the reader that the federal S&L system was not as significant in 1933 as was the establishment of the Home Owners Loan Corporation.
tral consideration. For example, Bank Board regulations under the original Home Owners' Loan Act contained a provision enabling a lender to raise the interest rate in a mortgage during its term.\textsuperscript{31} We do not know how often this provision was used. In any case, it was eliminated in the Home Loan Bank Board reorganization in 1949\textsuperscript{32} and has not reappeared.

In addition, Horace Russell, one of the architects of the federal S&L system, admonished that long-term assets should be funded with long-term liabilities. That is, if the sources of funds are of principally short-term duration, they may disappear and be replaced by higher cost funds, putting the lending S&L into a loss position. Russell's comment, made in 1956, was actually directed at the Federal Home Loan Bank System, which ceased making direct mortgage loans in 1949, but should be deemed equally applicable to the federal S&Ls:

> In normal and boom times, the Federal Home Loan Banks should promote, develop and use a sound method of financing their lending for long term mortgage lending. They ought not to yield to the temptation of using short term borrowings to finance long term lending. If they do so, then when financial crisis comes they will get scared . . . .\textsuperscript{33}

It appears that this temptation—to use short-term funds in order to finance long-term assets—was precisely the initial cause of the S&L disaster some thirty years later. However, the scenario was not quite that simple.

\section*{II. The Maturing Period}

For some forty-five years after its creation, the federal S&L effort may fairly be considered a complete success. Homes were built, sold and financed. Mortgages were widely offered and reasonably priced. Savings grew at rates that depositors accepted as equitable. The institutions prospered. Indeed, one commentator wrote that

> [t]he prospects of the savings and loan business in 1959 are better than at any time in their 120-year history. The laws on the books, State and Federal, have been perfected to provide not only for the greatest possible safety and for convenience and availability, but also for an economy of operation which results in a comparatively high rate on savings.\textsuperscript{34}

\footnotetext{31}{See 24 C.F.R. § 203.11 (1938). The regulation provides in pertinent part that [the lender] may incorporate into its note and mortgage forms or other instruments securing the debt a provision whereby the stipulated rate of interest may be increased at the option of the association; provided, however, that the association may not exercise such right in less than 3 years from the date of the loan and then only upon at least 4 months' written notice to the borrower.}

\footnotetext{32}{13 Fed. Reg. 6469 (1949).}

\footnotetext{33}{H. Russell, \textit{supra} note 5, at 51.}

\footnotetext{34}{\textit{Id.} at 8.
Deposits have remained the S&Ls' major source of funds since their creation. When the federal S&Ls were created, essentially all of their loan funds came from depositors; by 1958, the percentage was still well over ninety percent and almost half of the remainder represented Federal Home Loan Bank loans that could be repaid over a ten-year period. Apparently, in the early years of the federal S&L system, such deposits were deemed the equivalent of long-term funds and were considered available to finance long-term assets—real estate mortgages—without undue risk.

The federal S&L system incorporated the state law concept that traditionally required state association depositors to give the association a number of days' notice before a deposit could be withdrawn:

Banks contract to pay savings in thirty, sixty or ninety days and lead the public to believe that their savings will be thus available, but they know that the New York State banking law authorizes the Banking Board of New York, made up principally of bankers and one savings and loan man, to defer indefinitely payment of withdrawals of any deposits. Many other States have similar laws.

Presumably, this delay added a long-term quality to S&L deposits. The notice was rarely required by depository institutions, but it was invoked "in times of uncertainty or emergency."

By 1988 savings accounts were regarded as short term in nature and, as the source of funds for long-term, fixed-rate mortgages, subject to "a high degree of interest rate risk." One cannot pinpoint the moment that S&L deposits changed from long term to short term in nature, but three dates are illustrative.

On May 2, 1972, the Supreme Judicial Court of Massachusetts decided

35. See id. at 651, Table 6.
36. See id. at 71.
37. Russell, one of the creators of the Federal S&L system does not say this specifically. He strongly counsels against relying on short-term funds as a financial base for long-term mortgages, and he has no problem with the savings deposit structure. See H. Russell, supra note 5, at 51. He also notes the protection that S&Ls have through law and by the deposit contract against paying out deposits in times of stress. See id. at 69-70, 273-74.
38. Id. at 69; see also Alter v. Security Bldg. & Loan Co., 58 Ohio App. 114, 16 N.E.2d 228 (1937) (noting the right of a bank to withhold repayment of a deposit under either statute or agreement).
39. H. Russell, supra note 5, at 299; see also P.Z. Pilzer & R. Dietz, Other People's Money: The Inside Story of the S&L Mess 34 (1989) ("On March 6, 1933, the mutual savings banks in New York City—where there were more of them than anywhere else—began to enforce the advance-notice rules. This extreme measure had been taken only twice before, in the panic of 1907 and during World War I.").
41. Our discussion will be restricted to the S&Ls' principal source of funds—their deposits—although the S&Ls evolved to become increasingly dependent on borrowed money. See Cacy, Thrifts in the Troubled 1980s: In the Nation and the District, Fed. Reserve Bank of Kansas City Econ. Rev. 3, 5-7 (Dec. 1989). Between 1965 and 1979, for example, deposits as a source of funds diminished from 85% to 81%. See id.
Traditionally, savings accounts had little liquidity; to obtain one's money, it was usually necessary to appear at the depository institution in person, passbook in hand, and effect a withdrawal over the counter. As "back-office" procedures improved to the general satisfaction of the public, a number of states, including Massachusetts, changed their laws to allow withdrawals (subject to wording differences) "at such time and in such manner as the [S&L's] by-laws direct." 43

The Consumer Savings Bank passed by-laws enabling its depositors to withdraw funds through an instrument that directed the Bank to pay to the order of a named payee. The Negotiable Order of Withdrawal, or NOW account, was born. This instrument resembled and functioned like a check. 44 Because the deposit did not change its character from that of a savings account, and because it bore the interest typical of savings accounts, the Consumer Savings Bank had nicely sidestepped the general federal prohibition against paying interest on demand deposits, 45 giving consumers the equivalent of an interest-bearing demand account. 46 Savings accounts became checking accounts; long-term funds became short-term funds.

Irrked at the state action undermining the federal prohibition against interest on demand deposits, Congress validated the NOW account in 1973 in only Massachusetts and New Hampshire on an experimental basis—elsewhere it was prohibited by federal law, whether it was issued by a state or federal institution. 47 Permission to offer NOW accounts was expanded gradually and was ultimately extended throughout the United States in the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA"). 48

A second useful date is April 14, 1976, when the New York Legislature passed a bill 49 authorizing New York S&Ls to offer demand deposits. The new law responded to a New York Court of Appeals decision that the type of NOW account power validated by Consumer Savings Bank in Massachusetts 50 would be impermissible in New York because it

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44. There is general agreement today that Negotiable Orders of Withdrawal are checks under the Uniform Commercial Code. See B. Clark, The Law of Bank Deposits ¶ 10.9(4)(c), at 10-56 (SUPP. 1982).
45. See 12 U.S.C. § 371a (1988). While this section applied only to member banks, its principle was applicable to S&Ls through their general prohibition against opening demand accounts. Their right to do this came later.
50. See supra notes 42-43 and accompanying text.
made thrift institutions too similar to commercial banks. This statute conformed to the general movement of the time to give expanded powers—including NOW, checking or demand deposit powers—to thrifts.

The ability to access deposits through check-like instruments was further enhanced by the growth of electronic facilities. The availability of electronic teller machines on a 24-hour-a-day, 7-day-a-week basis, created a more flexible and immediate path to one's deposits, adding to their liquidity and short-term nature. Federal thrift institutions in particular were granted authority beyond that given to their commercial bank competitors to use electronic terminals for withdrawal purposes. Federal S&Ls were authorized to use such remote service terminals without reference to state line barriers, thereby further expanding their customers' access ability.

A third date is October 15, 1982, when the President signed the Garn-St. Germain Depository Institutions Act of 1982 ("DIA"), giving federal S&Ls limited authority to offer demand accounts.

The "hold" period that presumably enabled S&Ls to require notice from withdrawing depositors and added a long-term nature to savings accounts has also changed over the years and helped to turn deposits into short-term investments. Originally, federal S&Ls had the ability to withhold deposits for thirty days. State-insured institutions had a less clear prescription, but it was established that accounts payable on demand could not be insured. Today, federal S&Ls have limited power to issue accounts payable on demand. In addition, even their savings accounts require only a seven day hold. Thus, the liquidity of savings accounts has vastly increased, modifying their long-term quality to a short-term one.

53. See F.E. Balderston, supra note 7, at 7.
55. See 12 C.F.R. § 545.141(b) (1989). This authority was relied upon by the Comptroller of the Currency in his Interpretative Ruling of December 12, 1974 to the effect that customer-bank communication terminals, or CBCTs, are not "branches" and may be established by national banks without the state line limitation imposed by the McFadden Act. The Ruling was annulled by Independent Bankers Ass'n of Am. v. Smith, 534 F.2d 921, 935-36 (D.C. Cir. 1976).
57. Id. at § 312, 96 Stat. at 1496-97 (codified as amended at 12 U.S.C. § 1464(b) (1988)).
59. See 24 C.F.R. § 301.8 (1938).
61. See 12 C.F.R. § 563.6(b) (1989). The definition refers to demand accounts and prescribes that they shall be accounts with less than a seven day hold. Savings accounts are defined as accounts that are not demand accounts. See id.
The financial condition of the S&L industry and its potential problems clarify as the policies of the 1960s are considered. Required to finance principally long-term assets, the S&L industry relied for its funds upon liabilities that were increasingly short term. If those short-term assets became more expensive or if there were alternative investments for such assets that were more lucrative to the depositor/investor, a rocky road resulted.

The S&Ls did have some protection through the regulation of the amounts they were permitted by law to pay on their deposits. Before 1966, federal S&Ls could pay whatever they and their depositors agreed to, so long as earnings justified the payments. In 1966, legislation changed that situation.

A minor rise (by today’s standards) in interest rates caused by a shortage in lendable funds attracted Congress’ attention to the problem of the rates that financial institutions could pay on their deposits. With even less insight than one normally expects from our governing legislators, Congress reasoned that if all depository institutions paid less for their money, they could charge less for their loans. It then enacted a statute that gave the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board, in cooperation with each other, the power to set ceilings on deposit interest payable by the institutions regulated by each.

This limiting regulation afforded S&Ls limited protection against rising costs. Entirely aside, however, from the fact that S&Ls could not hope to retain their deposits if their regulator-established ceilings became misaligned with market rates, they were still not protected from the rising cost of funds. First, after a brief period of regulation, deposits of over $100,000 were freed from rate limitation. Second, S&Ls were raising money increasingly from sources other than their depositors through market rate investment vehicles. Third, even the regulated rates rose over time.

A fourth factor that increased the instability of S&Ls was the existence

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62. See S. Rep. No. 1601, 1966 U.S. Code Cong. & Admin. News 2994, 3000 ("Section 4 of the bill would for the first time give the Federal Home Loan Bank Board clear legislative authority to place limits on rates of dividends or interest . . . .").

State S&Ls were governed by too many different systems even to attempt coverage here and, even if insured by the FSLIC, the interest they paid on deposits was not governed by any federal law.

63. See id. Congress acknowledged that market forces also had a good deal to do with rates but vastly underestimated the power of those forces. It finally did acknowledge its error in 1980 with the enactment of DIDMCA; see supra note 48.


65. See 12 C.F.R. § 526.5-1 (1971).


67. Thus, on a one year $1,000 certificate of deposit, an S&L could pay a maximum of 5% in 1968, see 12 C.F.R. § 526.4(b) (1968); 5.75% in 1971, see 12 C.F.R. § 526.5(a)(2) (1971); and 6.5% in 1974, see 12 C.F.R. § 526.5(a)(2) (1974).
of usury laws (based originally on religious precepts) that regulated the yield that S&Ls could derive from their loans. Long discredited by economists,68 usury laws existed in most states through the 1970s. These laws limited the interest that could be charged on consumer real estate loans.69 The ceiling rates varied from a low of six percent to a high of twelve percent; over half of the states had ceilings of eight percent or less.70

III. THE PROBLEM—PERCEIVED AND UNPERCEIVED

We reach now some of the central characters in our tale: the regulators. The regulatory process exists because we assume that those with special expertise can accept the principles of governance, laid down in statute and explained in judicial interpretations, and apply them to the real world. These regulators are presumably experts and are relied on not to apply the unsophisticated standards of the market place to their functions, but rather to bring to their work a higher and deeper knowledge. We assume that they will do what we, because of our lesser knowledge, cannot do. We quite properly hold them to higher standards.

In their Federal Regulatory Process, Edles and Nelson wrote that "[a] principal reason for the creation of administrative agencies was to permit the exercise of informed discretion in specialized fields."71 For S&L regulators, the courts have written: "It is reasonable to assume that Congress intended to repose ultimate authority with respect to . . . [what a federal S&L may do] in those who are duly qualified to exercise that authority by education, training, and experience."72

As part of our dual banking structure, the S&L industry is regulated at the federal and the state levels. At the federal level, we have had—up to the effective date of the relevant provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 198973 ("FIRREA")—the Federal Home Loan Bank Board ("Bank Board") as the primary regulator of the federal S&L system and the Federal Savings and Loan Insur-

68. "On the basis of a summary of the historical approach to the establishment of rate ceilings and institutional knowledge about them the [National Commission on Consumer Finance] must conclude that, on balance, rate ceilings are undesirable when markets are reasonably competitive." Consumer Credit in the United States, Report of the National Commission on Consumer Finance 108 (Dec. 1972). Economists generally believe that market rates should control because when usury limitations are at or above market rates, they are irrelevant, and when they are below market rates, they freeze borrowers out of the credit market and generally distort lending patterns.

69. According to a 1965 study, all states but three (Maine, New Hampshire and Massachusetts) have usury laws. See Curran, Trends in Consumer Credit Legislation 15 (1965).

70. See id.


 ance Corporation ("FSLIC") as the primary federal regulator of the federal S&L insurance operations. FIRREA replaced the Bank Board with the Office of Thrift Supervision of the Treasury Department ("OTS") and the FSLIC with the Savings Association Insurance Fund ("SAIF") of the Federal Deposit Insurance Corporation ("FDIC").

At the state level, legislatures create whatever supervisory bodies are deemed necessary. Generally, the state banking department or its equivalent will be the regulatory body. Often, a subdivision of that body regulates the local S&L system.

There are cross-overs between the state and the federal regulators. For instance, through the period covered by this Article, most state S&Ls were insured by the FSLIC, a federal body. (Through the operation of FIRREA they are now insured by the FDIC.) FSLIC quite naturally needed to protect its insurance fund and therefore had, until its elimination, powers to supervise those S&Ls in the state system that carried federal insurance.

Through 1966 federal regulators (the commercial bank regulators as well as those assigned the S&Ls) were hindered by a cumbersome process that often proved ineffective and resulted in delay. They could close institutions, but it was difficult for them to deal with lesser problems. To give them the greater variety of powers they required, Congress enacted The Financial Institutions Act of 1966. Its purpose is summarized in the Senate Report:

S. 3158 would grant to the Federal agencies supervising banks and savings and loan associations—the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board—authority to issue cease-and-desist orders or suspension or removal orders subject to standards and procedures designed to protect both the institutions involved, and their officials and the depositors, savers and others interested in the sound and effective operation of the financial institutions. These powers would be granted, as intermediate powers short of conservatorship or withdrawal of insurance, in order to prevent violations of law or regulation and unsafe and unsound practices which otherwise might adversely affect the Nation’s financial institutions, with resulting harmful consequences to the growth and development of the Nation’s economy.

The Senate Report notes that Congress acted in response to a request

74. Until FIRREA, the FSLIC operated "under the direction [of the Federal Home Loan Bank Board] and operated by it . . . ." The Federal Home Loan Bank Act, 48 Stat. 1256 (1934).
75. See FIRREA, supra note 73, § 301 at 278 (to be codified at 12 U.S.C. § 1462a).
76. See id. § 211, at 219 (amending 12 U.S.C. § 1821(a)).
79. Id. at 3533.
of the major federal financial regulators. In language reminiscent of more recent pleas to Congress, those regulators joined in a letter stating that

[t]he continued economic growth of this country is clearly dependent upon the existence of financially sound and capably managed private lending institutions. The great majority, by far, of the financial institutions affected by this bill are soundly managed and operated. However, our financial system has not been entirely free from supervisory problems, and unlawful, unsound, or irregular practices have appeared in some cases. Even though few in number, improperly conducted institutions could cause public concern that might extend to the entire industry. In such cases, it is essential that the Federal supervisory agencies have the statutory and administrative facility to move quickly and effectively to require adherence to the law and cessation and correction of unsafe or improper practices.

Existing remedies have proven inadequate....

The DIA of 1982 granted the thrift regulators “increased flexibility in order to effectively assist troubled and financially distressed institutions.”

The roots of the S&L crisis are interest mismatches between what the S&Ls must pay for their money and what they may earn on that money. In the 1970s the former (at least the principal portion of it—the deposits in the S&Ls) was regulated under the rules laid down in the legislation of 1966. The latter was governed by the usury laws. More significantly, however, the latter was dominated by the nature of the loans made: long-term, fixed-rate loans, for example, retain their earning potential over a period of years. They cannot be varied quickly in order to meet a lender’s rising costs. Their yields are insensitive to market changes.

The decline in the thrifts’ profitability began soon after the euphoric statement that opens this section. Rising interest rates in the 1960s forced the S&Ls to pay more for their money and, although they were still profitable well into the 1970s, their profit margins were lower. Indeed, as early as 1969, the editor of a massive study of the S&L industry noted that the reason for the decline in profits that began in 1960 “was the more rapid rise in the cost of money than in the return on assets.... This downturn reflected the insensitivity of yields on mortgages already in the portfolio of savings and loan institutions....”

80. Id. at 3536; see also N.Y. Times, June 20, 1990, at D1, col. 6 (President Bush’s son prohibited from holding office in S&Ls).
82. Joint Explanatory Statement of the Committee of Conference on DIA, at 85.
83. See supra notes 62-64 and accompanying text.
84. See supra note 34 and accompanying text.
85. J. Friend, A Study of the Savings and Loan Industry 5 (U.S. Gov’t Printing Off. 1969). Friend also noted that S&Ls “have the most specialized asset structure and the greatest imbalance between the maturity structure of assets (mainly long-term residential
By 1980 market interest rates exceeded the rates earned on a substantial portion of the S&Ls portfolios. "The long period of prosperity for thrifts ended abruptly in the early 1980s. Large losses replaced profitability, as the thrift industry's [return on assets] averaged -0.42 percent from 1980 to 1982. . . ."86 In 1981 the average cost of funds for FSLIC-insured institutions (10.92%) exceeded the interest return on their mortgages held (9.91%).87 What were the regulators, principally the Bank Board with its superior "education, training, and experience,"88 to do at this point?

Ironically, the major pressure upon the Bank Board at this time was to increase the money costs of the S&L system. In early 1977, a new word—disintermediation—came into fashion in banking circles. It described the consequence that, because market rates exceeded allowable bank and S&L rates, those with sums to invest (or save) looked for places other than traditional depository institutions to invest their money. Banks and S&Ls could compete in the free market when the available funds were in excess of $100,000 because the restrictions of Regulation Q did not apply above that figure. Where the investor, typically the small saver, was dealing in lower amounts, he was stuck. If he wanted to write checks on his deposits, he had to deal with one of the traditional institutions; he could not even consider an alternative, assuming that one was available to him, because the institutions that were free of Regulation Q-type restrictions could not under law offer checking privileges.

The log-jam was broken with the invention of the cash management or money market account by some of the large brokerage houses, led by Merrill-Lynch. Through arrangements with banks, these brokers invented a device that enabled small depositors to earn interest at or near market rates and, at the same time, have a checking and a credit card facility. Money poured out of the banks and into the funds.

The banks, particularly the large banks, pressured Congress to relieve them from the restrictions of Regulation Q. Their efforts met success in 1980 with the enactment of DIDMCA which mandated that statutory control over the rates that depository institutions, including S&Ls, could pay on their deposits end by March 31, 1986.89 Essentially, Congress acceded to what it saw but did not acknowledge in 1966—that the forces of the market, not the regulations of administrators, would ultimately determine interest rates.

The S&Ls and their regulators were caught between a rock and a hard place. Faced with a rising cost of funds, they had to decide how to ad-

86. Cacy, supra note 41, at 7.
88. See Securities Indus. Ass'n, supra note 72 and accompanying text.
89. This, however, left intact the long-standing prohibition against paying interest on demand deposits. See 12 U.S.C. § 371a (1988).
dress new legislation that, in the name of a fair deal to low income consumers, threatened to increase their costs even further.

Basically, the Bank Board opposed the new legislative proposals. It downplayed the likelihood that there might be disintermediation by stressing the comparability of S&L rates with market rates and making light of the consumers' need for liquidity. One cannot be certain, but the Bank Board may well have been motivated by what it perceived as the psychology of the S&L saver base. Generally more rural and less financially acute than those who deposited in the large banks, they were probably less inclined to disintermediate to the money market funds than their large bank counterparts.

Recognizing the need for higher returns to their savers, the S&L regulators clearly preferred the long-term certificates, yielding modestly higher rates, to any general deregulation of savings accounts. The prime example of this preference was the Bank Board's 1978 introduction of the so-called money market certificate, which paid up to eight percent annually on certificate accounts as low as $1,000—but with the money locked in for a minimum of eight years. The Bank Board deemed this to be “competitive with interest rates available in the market on instruments possessing similar characteristics.”

Robert H. McKinney, Chairman of the Bank Board, spoke and submitted a report to the Subcommittee of Financial Institutions of the Senate Banking Committee on April 11, 1979 in connection with the deposit interest rate problem. He showed clear concern throughout his presentation for the solvency of the S&L system. In remarks supporting his written submission, he stated:

It is frankly a heroic task to try to meet the need and clear demands of all savers, retain the solvency of the savings institutions, provide adequate funds for the housing markets, and at the same time, concern ourselves about the other consumer, the borrower, all during a highly inflationary period. At present, our ability to raise deposit rate ceilings is restricted to concerns over savings and loan profitability and viability.

Chairman McKinney showed none of the enthusiasm for allowing de-
posit interest rates to rise, unlike the Comptroller of the Currency, prime regulator of the national banks,95 or by the Chairman of the Federal Deposit Insurance Corporation, prime federal regulator of the state banks.96 Thrifts were still profitable when this Bank Board report was given, but the profit margin was dropping. The report stated that the S&Ls would drop forty percent in profitability in the second half of 1979 if interest rates remained stable: "The decline will be much more precipitous if interest rates increase during 1979."97 Interest rates did increase in 1979 and finally topped off in 1981 for rates in general98 and in 1982 when the cost of funds to the S&Ls99 reached an all time high. The thrifts generally became unprofitable early in 1980.100

Looking back over a decade within which the S&L system failed, one is hard put to fault Chairman McKinney for his 1979 performance. Had he succeeded in opposing the legislation, funds might well have been disintermediated out of the banking system to the brokers' money market funds. This probably would have destroyed, and certainly crippled, the S&L system. The effects on the home mortgage market could have been devastating. Clearly, the Bank Board evidenced due concern for the needs of its S&L constituency.

Chairman McKinney did propose that the lending powers of the S&Ls be broadened to enable them to lend shorter term and to a different group of borrowers in order to increase their earnings and meet their increased expenses. The following appears in his formal report:

We wish to note that preliminary Administration reports indicated that increased yields for savers must be accompanied by appropriate mechanisms - such as nationwide VRM [variable rate mortgage] authority - to enable thrifts to afford to pay for increased interest costs. It does considerable harm to unleash competitive pressures on the liability side without unfettering the asset side as well.101

The Bank Board's recommendations were incorporated into the law. The deregulation of interest rate payments was quickly accompanied by

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95. See id. at 47 ("We believe it's time to commit ourselves to a gradual phasing out of the rate ceilings. . . ." (statement of John G. Heimann, Comptroller of the Currency)).
96. See id. at 63 ("In my opinion, it is unconscionable to continue a system wherein a big saver with $100,000 to invest earns interest at a rate twice as great as the small saver with $1,000 or less." (statement of Irvine H. Sprague, FDIC Chairman)).
100. See Morris & Merfeld, supra note 40, at 5.
101. Equity for the Small Saver: Hearings Before the Subcomm. on Financial Inst. of the Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 1st Sess. 42 (1979) (Statement of Mr. McKinney); accord id. at 47 (Comptroller of the Currency expressing similar sentiments).
the deregulation of thrift powers. Section 401 of DIDMCA enabled federal S&Ls to lend and invest in a broad variety of areas (soon to be added to by the 1982 legislation, which lies ahead), Section 402 authorized them to issue credit cards and Section 403 authorized trust powers. In addition, Section 501 essentially removed state usury law limitations on residential real estate (including cooperatives and manufactured homes) mortgage loans. Presumably the S&Ls were now poised to increase their earnings in two ways: first, they could continue to lend in their traditional residential mortgage area unfettered by state usury law limitations; and second, they could expand into new areas. We still cannot fault the regulators.

The opportunities given to the S&Ls in 1980 to explore new areas, both on the liability and asset sides, was considerably expanded in 1982 through passage of the DIA. Again recognizing the needs of the federal S&Ls and clearly appreciating the additional pressures put on the S&Ls by their developing ability to pay market rates upon their deposits, the Bank Board reported to the Senate Banking Committee in 1981:

The Bank Board is convinced that the current statutory asset constraints facing thrift institutions are simply inconsistent with the ability of those institutions to compete effectively in a marketplace characterized by payment of market rates on deposits. Given that Congress has set in motion a deposit interest rate decontrol process, already substantially underway, that will eliminate all controls by 1986, it is imperative that thrifts receive asset-side empowerment capable of generating the earnings needed to support competitive rates.

The Bank Board was again successful. Federal S&Ls were now accorded limited powers to take demand deposits and to offer money market deposits to compete with the non-bank money market funds. They could lend on the security of nonresidential real estate, make both secured and unsecured, commercial and agricultural loans, as

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102. The general philosophy of deregulation has itself been faulted as the cause of S&L failures. "[l]f we must point a finger, it would have to be directed toward the Reagan deregulation philosophy of 'everything goes' and 'every man for himself.'" Sprague, Unrelated Series of Events Led to S&L Crisis, Am. Banker, May 3, 1989, at 4.

103. I have summarized the Act's provisions for ease of reading. Also included was authority for states to override the usury law freedom within three years, an authority that only a few states used. Section 511 of the Act contained a provision freeing commercial loans of $25,000 (amended in 1980 to $1,000) or more from state usury laws; again supported by state authority to override. The commercial usury freedom was written to last only three years, however, and expired by its own terms.


105. Statement of Federal Home Loan Bank Board to Senate Comm. on Banking, Currency and Housing, Serial No. 97-37 on S.1720, at 666.


107. See id. § 327, 96 Stat. at 1501.

108. See id. § 322, 96 Stat. at 1499.

109. See id. § 325, 96 Stat. at 1500.
well as make ordinary consumer loans.\footnote{See DIA, supra note 56, § 329, 96 Stat. at 1502.}

As the S&L industry entered the 1980s, three factors affected its performance. First, Washington's regulatory authority was refined to give regulators the more sophisticated powers deemed necessary to keep the industry in line. Second, rates rose as a result of general inflationary pressures and of the freedom given to the banking industry in the 1980 legislation. Finally, to cope with increased costs, the S&Ls were afforded powers to increase their participation in what had previously been the domain of the commercial banks.

The Bank Board, acting alone and through its affiliate, the FSLIC, took a series of actions in the early 1980s to sustain the S&Ls through the evolving period. These actions had two common denominators. First, their general objective was to support the S&L system through what the S&L regulators hoped would be a relatively brief troubled period. Second, they reflect the Bank Board's clear understanding that the S&Ls were in trouble. Again, the problems were expected to be transient: a little good medicine, the passage of time, and the industry would be back on its feet. That all could go wrong and that the industry could self-destruct was implicitly deemed inconceivable. One is still hard put to fault the Bank Board. American industry traditionally goes in cycles; 1980 could have reasonably been considered the trough in another cyclical movement. Good administrators apply a remedy, tough it out, and wait for the correction to occur. In other words, regulators were surviving on hope.

A. Regulatory Accounting Procedures ("RAP")

Beginning in 1981 the Bank Board instituted a series of new accounting devices that FSLIC-insured S&Ls could use to improve their appearances. One of the first enabled insured S&Ls to amortize gains and losses from the sale of most mortgages and mortgage-related securities.\footnote{See 46 Fed. Reg. 50,048 (1981) (codified at 12 C.F.R. §§ 561, 563 and 563c).} As most of these securities were diminishing in value, the practical effect of the authorization was to allow the S&Ls to spread losses over an extended period of time rather than recognize them as they occurred, as required by generally accepted accounting principles ("GAAP").\footnote{112. The Bank Board recognized that this was a departure from GAAP but concluded that "the deferral of gains and losses reflects more accurately the actual financial impact on an institution of the sale or other disposition of mortgages and securities." \textit{Id.}} The Bank Board clearly intended the change to "assist thrift institutions caught in an earnings squeeze."\footnote{113. \textit{Id.} Accounting is a subtle art. It has more recently been reported that the application of GAAP rather than the now discredited RAP [Regulatory Accounting Principles] can put an otherwise solvent thrift into conservatorship. \textit{See} Rose, \textit{Did Franklin Savings Get a Raw Deal?}, Am. Banker, Mar. 5, 1990, at 1, col. 1.} It has been reported that the accounting profession, "too sympathetic to the industry, which was a big client for many accounting firms," did not oppose the relaxation of its own
requirements.\textsuperscript{114}

B. \textit{RAP for Appreciated Assets}

In another departure from GAAP, the Bank Board authorized insured S&Ls to account for appreciated assets at their newly appraised higher worth rather than at book value.\textsuperscript{115} The Bank Board again recognized the shift from GAAP to its own rules\textsuperscript{116} and also acknowledged that the change was made because of "the present state of the industry."\textsuperscript{117}

C. \textit{Merger Accounting}

The thrift regulators and the accountants jointly accepted a variation on the traditional method of accounting upon the merger of two entities that enabled the merged thrifts to (i) write down their mortgage assets to market value, (ii) write up equivalently an item called goodwill, followed by (iii) an eight year write-up of the mortgages back to par and (iv) a forty year write-down of the goodwill.\textsuperscript{118} Agreements based on this modified accounting method may have been invalidated by 1989's FIRREA; the issue is currently being fought in the courts.\textsuperscript{119}

D. \textit{Capital Certificates}

In order to increase the capital of tottering thrift institutions, Title II of the DIA authorized the FDIC to buy from insured S&Ls "net worth certificates . . . for such form of consideration as the [FSLIC] may determine."\textsuperscript{120} In 1982, the Bank Board set up a procedure\textsuperscript{121} that essentially enabled an S&L in need of additional capital to write a piece of paper reflecting this amount and call it a net worth certificate. The FSLIC would then buy it in exchange for its own promise to pay and the S&L would be permitted to consider that sum as an addition to its capital. No money would change hands, but the S&L would be presumably healthier with its capital augmented. Again, the device was clearly designed with a foundering industry in mind. The Bank Board described it as intended to support "a broad range of institutions which have suffered operating losses and therefore a deterioration of net worth, particularly as a result of their mortgage lending activities."\textsuperscript{122}

\begin{thebibliography}{122}
\bibitem{116} See id.
\bibitem{117} Id.
\bibitem{118} See id.
\bibitem{120} See Garsson, \textit{Government Loses Case on Goodwill Writedowns}, Am. Banker, Aug. 9, 1990, at 1, col. 5.
\bibitem{121} DIA, supra note 56, § 202(a), 96 Stat. 1469, 1489.
\end{thebibliography}
E. Net Worth and Averaging

In 1980, stimulated by an amendment to DIDMCA\textsuperscript{123} that enabled the Bank Board to set reserves on insured accounts between three and six percent,\textsuperscript{124} the Bank Board established a net worth requirement for insured S&Ls of four percent per annum based upon all liabilities.\textsuperscript{125} This percentage was later reduced to three percent.\textsuperscript{126} The Bank Board's concern with the failing health of the S&Ls is evident throughout the regulations. The Bank Board stresses the intent of Congress to rely upon its expertise in selecting the correct reserve percent between three and six. It acknowledges the rising cost of deposits and the diminishing yield on loans. It recognizes the difficulty that insured institutions will have in maintaining even a four percent net worth. And it reduces the net worth requirement—with disastrous consequences—to meet the needs of the foundering institutions. Little notice seems to have been given, however, to the fundamental idea that a risky institution's capital requirement should go up, not down.\textsuperscript{127}

We are almost stunned today to read what the Bank Board merely noted in passing when reducing net worth from four to three percent in 1982: "Such retention [of a higher net worth] is unnecessary because the Board's supervisory staff is able to resolve situations involving troubled institutions successfully where the net worth of the institution is substantially below the four percent level."\textsuperscript{128}

In addition, under a longer standing Bank Board regulation,\textsuperscript{129} S&Ls were able to average the liabilities upon which the net worth would be computed over a five year period. Thus, given a rising liability pattern—i.e., "rising deposits"—the actual net worth required at any particular time will lag well behind any current liability total. As S&Ls grew through the early 1980s, they were thus largely unrestrained by what is generally considered the single most important control on an institution's size—its capital base.

In one major effort to support the foundering S&Ls through the 1970s, the Bank Board failed. Variable interest rates and freedom from state usury restrictions, if granted early enough, might have saved not only the S&Ls, but also retained their industry's traditional structure. In 1969, when addressing the Senate Banking Committee on the subject of mortgage interest rates, Bank Board Chairman Preston Martin was appar-

\begin{itemize}
\item \textsuperscript{123} DIDMCA, supra note 48.
\item \textsuperscript{124} See id. § 409, 94 Stat. 132, 160.
\item \textsuperscript{125} See 45 Fed. Reg. 76,111 (1980) (codified at 12 C.F.R. §§ 561, 563). This net worth requirement—roughly the equivalent of a capital requirement—was applicable to member-owned mutual institutions as well as privately owned stock institutions. In a later regulation reducing net worth to three percent, the Bank Board refers to net worth as "a measure of capital." 47 Fed. Reg. 3543 (1982).
\item \textsuperscript{126} See id.
\item \textsuperscript{127} See Capital Standards, Banking Expansion Rep., Sept. 3, 1990, at 5.
\item \textsuperscript{128} 47 Fed. Reg. 3543 (1982).
\item \textsuperscript{129} See 12 C.F.R. § 563.13(b)(2)(ii) (1980).
\end{itemize}
ently sufficiently uninterested in usury laws and in variable mortgage interest rate structures not to mention them at all. Much later, in 1989, a different Bank Board Chairman, Edwin J. Gray, blamed Congress for not authorizing variable rate mortgages when they were needed in the 1970s, but did not mention the Bank Board’s role in the effort to get them. Finally, in 1975 the Bank Board, taking an interest in the subject, made a strong plea for variable rate structures both to Congress and in its own proposed Regulations. Nothing came of all this, however, before the 1980 federal legislation, the DIDMCA.

When the Bank Board finally stiffened its regulation of federal S&Ls in 1985 by establishing higher net worth requirements and eliminating the five-year averaging device, it was probably too late to stop the toboggan. The Bank Board recognized the “relative laxity” of its net worth requirements and “inadequacy of the present capital requirements.” It also noted:

It is well documented that not all institutions are using growth to restructure in a prudent, safe and sound manner. In fact, some institutions are growing so rapidly that the management of such institutions is unable to make prudent investment decisions or to implement proper underwriting techniques in order to ensure the acquisition of sound assets.

The Board justified its position largely in terms of the broad new powers that DIDMCA of 1980 and Garn-St. Germain of 1982 gave to the S&Ls and the need for more stringent net worth requirements to support the more dispersed and riskier forms of lending. One is hard put, however, to ascertain the bright line apparently perceived by the Bank Board between costlier deposits justifying lower net worth from 1980 to 1982 and riskier loans justifying higher net worth in 1985. In evaluating the perception of the Bank Board as regulator, it is also worth noting that the reduction of the net worth requirement to three percent came in 1982, the same year that Congress granted the broader lending powers to the S&Ls.

130. See Statement of Preston Martin, supra note 90. He did note, in both his oral and written submissions, that § 5 of the Home Loan Bank Act, which deals with interest rates and at that time essentially applied state rates to federal S&Ls, was being examined, but he made no recommendation.


136. Id.
IV. THE DISASTER

By 1982 the S&L system was set up for a general recovery. The regulators were in place with new powers and the flexibility to avoid what were perceived as short-term problems. Had the regulators then brought a heavy hand to the industry—imposed higher net worth requirements and closed down the institutions that failed to measure up—they would have destroyed the S&L system. In retrospect, this course would have been a great deal less expensive than what actually transpired. But in 1982, stripped of sophisticated trappings, the industry in general and its regulators in particular were surviving on hope. In all justice, however, the Bank Board cannot be faulted for its optimism.

The former Chairman of the United States League of Savings Institutions put it this way at a recent conference: "The hope [in the early 1980s] was [that] we could get through this first hump, that interest rates would go down, and [that] we could save the bulk of the industry."137 A Federal Reserve Bank economist, looking back from 1989, expressed a somewhat more knowing view: "The conclusion is that forbearance was a gamble for the FSLIC, and its cost has turned out to be significant."138

In retrospect, it does not look like such a bad gamble. In 1976, when S&L profits were substantial and healthy, the S&Ls were largely restricted to real estate mortgage lending. The average cost of funds for FSLIC-insured institutions was 6.38% annually;139 the interest return on mortgages held by such institutions was 8.00%.140 The 1.62% differential between basic cost of funds and basic return was apparently sufficient. In 1981, the cost of funds exceeded the return on mortgages for the first time. This continued through 1982; but in 1983 the return once again exceeded cost of funds—this time by 1.23%.141

Optimism and reasonable gambles are part of the American way of life. Who could have foreseen that so much would go wrong at the same time? But not all of the S&Ls failed; over 2500 probably did, but some 1200 did not.142 Does this survival rate justify the regulators' confidence?

It is clear that no single factor caused the S&L disaster. Perhaps any

140. See id.
141. See id. The Federal Home Loan Bank Board Journal was discontinued in 1984 and not published again until 1988, at which time this information was no longer given. A later study shows that the interest income of the thrift institutions gradually increased from 1983 through 1988 but their expenses, including but not limited to interest expenses, also increased and at a greater rate. See Cacy, supra note 41, at 5, Table 1.
financial cataclysm—and the collapse of the American S&L system has been described as the most expensive event in our civil history—that has no single cause. We may, however, summarize and study the following as the elements that came together in the late 1980s to spell the end of the S&L system as we knew it (at a gross cost to the United States government and its taxpayers that may ultimately exceed $1 trillion).

A. The deposit/loan interest rate mismatch
B. The federal deposit insurance system
   1. Rates and terms
   2. Brokered deposits
C. Reduced net worth and other accounting gimcracks
D. Depression in the real estate market
E. Expanded powers improvidently used
F. Internal fraud and mismanagement
G. An uncontrolled state system
H. Inadequate regulation

A. The Deposit/Loan Interest Rate Mismatch

There is general agreement that the rise in the cost of money during the late 1970s precipitated the S&L crisis. It was the trunk from which all the other branches grew. Even the expansions in federal S&L powers contained in the 1980 and 1982 enactments were designed to make thrifts more bank-like and give them the opportunity to earn higher yields to offset their higher interest costs. Clearly interest rate mismatches were not the only—and perhaps not even the most important—problem. But the corrective measures that ultimately failed—regulatory attention that proved ill-conceived, and even mismanagement and fraud—all resulted from the initial problem that the S&Ls could not make money because they were paying more than they were earning. Even historical revisionist and ex-chairman of the FDIC Irvine Sprague, who "discount[ed] ... reports that the thrift industry was a victim of high interest rates [as] nonsense," seemed to agree that interest mis-

144. The cost of the S&L disaster is open to question. Numbers have been floated and revised—usually upward. Experts have estimated that the entire actual expense would be between $130 billion and $170 billion. See Nash, Savings Regulator Seeks 100 Billion for Bailout in Cal., N.Y. Times, July 31, 1990, at A1. Since, however, this would be paid for largely with borrowed funds, the total cost, including interest, might rise as high as $1 trillion. See id.; see, e.g., Hill, A Never Ending Story: An Introduction to the S&L Symposium, Stan. L. & Pol'y Rev. 21, 24 (Spring 1990) ("Because the financing is with 30- to 40-year bonds, interest costs will continue nearly to the year 2030, reaching a grotesque total of more than $1 trillion.").
145. These events are comparable to the nine causative events listed by A.S. Carron in his piece, The Thrift Industry Crisis of the 1980s: What Went Wrong, in The Future of the Thrift Industry, supra note 137, at 24-25.
146. See supra notes 84-88 and accompanying text.
147. See supra notes 102-10 and accompanying text.
matches at least started the problem.\footnote{Sprague, Unrelated Series of Events Led to S&L Crisis, Am. Banker, May 3, 1989, at 4, col. 1.}

B. The Federal Deposit Insurance System

1. Rates and Terms

The thrift crisis could not have occurred without the presence of federal deposit insurance.\footnote{One cannot conceive of what an economic downturn, coupled with the absence of deposit insurance, might have caused in the thrift system or, for that matter, in the financial system generally. Would funds have drained from the thrifts and banks at an earlier stage causing an earlier and perhaps smaller crisis? Would deposits have remained unpaid, stimulating something on the order of the 1932 bank crisis? Would a private insurance system have been created with very different effects upon the financial system?} Commentators have blamed the general federal deposit insurance system for the S&L collapse because premiums "were neither set high enough to cover catastrophic losses nor set to reflect the riskiness of the portfolios of individual institutions."\footnote{Barth & Brumbaugh, The Rough Road from FIRREA to Deposit Insurance Reform, Stan. L. & Pol'y Rev. 58, 66 (1990).} This lack of relationship between premium and risk encouraged S&L operators to gamble their deposits in risky ventures whose failures in turn led to failures of the S&Ls. In other words, the S&Ls owners had no downside: they would enjoy all profits and the insurance fund would suffer all losses.\footnote{Based upon this reasoning, massive changes in the insurance funds are being proposed. For an example, see Barth & Brumbaugh, supra note 150, at 65.}

The risks were exacerbated when, in 1980, federal deposit insurance was generally increased to $100,000 for both commercial banks and thrifts, giving more than ample coverage to the typical depositor. The narrow construction of the statutes further exacerbated the risks by allowing a single depositor (i) to have as many $100,000 accounts as he wished in separate banks and (ii) to have several accounts in the same bank so long as they were legally different (for example, one in one name, one jointly, one in trust). The risks were also increased by the federal insurers' policy of providing coverage to uninsured deposits in situations where the institution was deemed to provide some social or economic benefit to the economy that should not be undercut through its failure.

Comparison of the S&Ls to the commercial banks is useful. The S&Ls, with deposit insurance, failed; the commercial banks, with essentially the same form of insurance, did not. Does this indicate that the insurance concept is sound but the thrift system is not? Or, on the other hand, is the commercial bank insurance system a disaster waiting to happen?\footnote{For an article comparing the S&L situation with the current standing of the commercial banks, see Bryan, Comment: Banking Crisis is Different and Could Be More Serious, Am. Banker, Aug. 1, 1990, at 4, cols. 1-4.} This question may be one of the most serious to arise from the thrift crisis. Indeed, we find ourselves today with regard to the commer-
cial banks in a situation not unlike that of the thrifts in the late 1970s. If the commercial banks are sound, we may proceed on course and all will be well. If, as some have cautioned, failures are on the horizon and the FDIC bank insurance fund is already insolvent, now would seem the time to take action. Perhaps, in the latter situation, well-honed action by Congress and the regulators might stave off a commercial bank disaster with consequential public costs.

Certainly the most obvious invitation to another financial disaster is concealment of problems by public officials who control the system. According to one scholar, proof of the FDIC's insolvency "is in confidential FDIC data," but "the agency is stonewalling researchers' requests for data." The FDIC flatly rejects the researchers' conclusion. "We simply don't agree that the FDIC fund is insolvent," said agency spokesman Alan Whitney. This Article shall assume what appears to be the correct position: that, despite the availability of a commercial bank insurance system that is comparable to the FSLIC system for S&Ls, the regulators are accurate to the extent that we are not on the brink of a widespread commercial bank failure.

2. Brokered Deposits

Under the federal deposit insurance system, brokers can pool deposits (each deposit limited to $100,000 or less) and deposit the pooled amount in a single S&L. Each depositor is fully insured. If the S&L is below par, it may even be forced to offer a higher rate on the deposit. In turn, the S&L must go into the market and make loans that yield a high enough rate to repay the deposit upon withdrawal. If the S&L is unsuccessful—i.e., if to get the higher rates that it requires, it makes risky loans that default—the FSLIC guarantees the deposits. These practices enable virtually all institutions to attract large volumes of funds from outside their natural market area irrespective of the institutions' managerial and financial characteristics. The ability to obtain de facto one-hundred-percent deposit insurance through the parceling of funds eliminates the need for the depositor to analyze institutions' likelihood of continued financial viability. The availability of these funds to all institutions, irrespective of financial and managerial soundness, reduces market discipline.

The accumulation of brokered deposits, the loss of market discipline and the risky loans made with the assurance of FSLIC insurance are frequently cited as fundamental causes of the S&L collapse. This risk was perceived in advance of the collapse by the FDIC and the FSLIC,

154. *Id.*
155. *Id.*
156. *Id.*
who took joint action in 1983 to eliminate the practice of pooling deposits for brokerage purposes in both commercial banks and the thrifts.\textsuperscript{158}

What appears in retrospect to have been a responsible act by the regulators was undone by the courts. In an action by a deposit broker against the two agencies, \textit{FAIC Securities, Inc. v. United States},\textsuperscript{159} the court found the FDIC/FSLIC proposed rule to violate the two applicable insurance statutes, and enjoined its implementation.\textsuperscript{160} The FSLIC's rule limited brokered deposits to five percent of deposits for insured institutions with less than three percent net worth.\textsuperscript{161} This action was clearly insufficient to meet the problem of brokered deposits first perceived by the FSLIC, and ultimately by all followers of the financial scene, as a cause of the S&L collapse.

\textbf{C. Reduced Net Worth and Other Accounting Gimcracks}

Closely related in concept to deposit insurance issues was the ability of the S&Ls to operate through regulatory fiat with unduly low net worth requirements and to conceal their malaise through imaginative accounting devices.\textsuperscript{162} Such factors clearly delayed the S&Ls' demise and probably intensified its ultimate effects.

\textbf{D. Depression in the Real Estate Market}

In the latter half of the 1980s, after a decade of unequalled growth, the United States real estate market began to subside. The S&Ls had regularly held home mortgages as the principal part of their portfolios. After being granted expanded powers in 1980 and 1982, they continued to hold large amounts of real estate paper, although major portions of it were now in commercial, rather than consumer, forms of real estate loans. Even in 1978, however, the portion of the thrift portfolios in real estate mortgages was only forty-six percent; by 1988 it had declined to twenty-eight percent.\textsuperscript{163}

Few commentators cite the overall real estate slump as the dominant cause of the S&L disaster. Some, however, do.\textsuperscript{164} Unquestionably, some S&Ls, particularly in the sunbelt, suffered grievously as a result of local real estate slumps.\textsuperscript{165}

\begin{footnotes}
158. See id.
159. 768 F.2d 352 (D.C. Cir. 1985).
160. Id. at 354, 363-64.
162. See supra notes 111-136 and accompanying text.
164. See Wall St. J., Nov. 5, 1990, at A6, col. 1 (quoting a government economist as saying that "the thrift crisis is a real estate crisis").
165. See N.Y. Times, Jan. 16, 1990, at D1; see also Fortune, May 11, 1987, at 61
\end{footnotes}
E. Expanded Powers Improvidently Used

We have already seen how in 1980 and 1982 Congress gave the federal S&Ls powers enabling them to engage in activities well beyond their basic and traditional business of making residential real estate mortgage loans. Essentially, they were becoming more like banks. The powers granted by Congress in 1980 included authorization to make loans, up to twenty percent of their assets, on the security of first liens on commercial real estate; the right to make consumer loans up to the same twenty percent ceiling; and the power to issue credit cards. In 1982 the new powers were expanded. The most noteworthy were the authorization to make secured commercial loans up to forty percent of assets, and to make unsecured commercial loans up to five percent (to become ten percent in 1984) of assets.

In the foregoing respects, the federal S&Ls resembled traditional commercial banks. In both 1980 and 1982, Congress empowered them to make investments of various sorts. These powers occasionally exceeded those granted by governing law to the typical commercial bank. In 1980, for example, federal S&Ls were permitted to invest in corporate debt securities, subject to the supervision of the Bank Board.

State legislatures followed Congress' lead by expanding the powers of state S&Ls. State S&Ls were often given broad-ranging powers enabling them to act essentially unrestrained. We shall speak more about this when we discuss the dual regulatory system.

Theoretically, S&Ls would increase their profits through use of the expanded powers. In fact, those powers only accelerated their doom. Business was sluggish as we moved into the 1980s and commercial banks were already finding their commercial loan departments strapped for profits. Forced to compete in this market, S&Ls necessarily scraped the (ascribing the Texas real estate crash as one of the two dominant causes of the S&L crisis; the other was "go-for-broke" management).

166. Thrifts are under a different regulatory system from that applicable to commercial banks. Thus, many of the underlying restrictions applicable to banks are inapplicable to thrifts. This gives both the thrift regulators and the Congress somewhat greater maneuvering room when acceding powers to the thrifts. For a decision to the effect that portions of the Glass-Steagall Act, which restricts the investment banking abilities of both thrifts and commercial banks, are not applicable to subsidiaries of S&Ls, see Securities Indus. Ass'n v. Federal Home Loan Bank Bd., 588 F. Supp. 749, 764 (D.D.C. 1984).

167. It is difficult to be precise about what commercial banks may and may not do. While national banks are subject to the National Bank Act, 12 U.S.C. §§ 38-42, state banks are governed by some 50 different statutory patterns. No two are alike and for the purposes of this Article it is not necessary to extract their provisions.

168. See Monetary Control Act of 1980, § 401. The Bank Board defined the type of corporate debt securities in which federal S&Ls may invest by regulation. See 48 Fed. Reg. 23,058 (1983). Among the qualities that permissible corporate debt securities were required to have was that they must be "rated in one of the four highest categories by a nationally recognized investment rating service." Id. This essentially precluded federal S&Ls from investing in "junk bonds," a form of investment that hurt the state S&L system.

169. See infra notes 177-79 and accompanying text.
bottom of the barrel for commercial loans. Inexperienced lending officers added another dimension of inefficiency. The default rate was high. To the extent that failing real estate loans were threatening the health of the S&Ls, their newly developed commercial loan portfolios only made matters worse. Although it is difficult to state categorically that the S&Ls would have been better off without the intensely sought expanded lending powers, this seems to be the case.

The interest-rate mismatch discussed above triggered the fall of the S&L system. Most of the problems encountered by the Bank Board and the FSLIC in the 1970s resulted from these mismatches. With the broader powers of the 1980s, the thrifts’ "major problem became poor asset quality."\textsuperscript{170}

F. Internal Fraud and Mismanagement

It is generally agreed that the S&Ls were mismanaged. Simple incompetence by inexperienced operators mixed with fraud resulted in badly conceived loans and investments, loans to officers and directors, sweetheart loans to affiliated businesses, cooking the books, bribery and outright embezzlement. These occurred in varying measures. The size of the various peccadillos is difficult to determine. A Congressional committee reported that fraud occurred in seventy percent of the failed institutions.\textsuperscript{171} A footnote to the report added that the fraud apparently "contributed to the insolvency of perhaps twenty percent."\textsuperscript{172} On the accumulated evidence, it is undeniable that internal fraud and mismanagement contributed substantially to the S&L failures.

G. An Uncontrolled State System

The dual system of S&L regulation is not subject to easy generalization. At the time of the developing S&L crisis, federal S&Ls were chartered by the Bank Board and state S&Ls were chartered by their state supervisory agencies. Federal S&Ls derived their powers primarily from the federal government, through the Home Owners’ Loan Act of 1933 and the regulations of the Bank Board. State S&Ls generally derived their powers from their particular state statutes and regulations. The FSLIC had regulatory authority over federal S&Ls in order to provide protection to the insurance fund. State S&Ls, as a result of the federal insurance system that governed most of them, were also subject to some FSLIC federal regulation, as well as the system of state regulation

\textsuperscript{171} Wall, \textit{The Tasks Ahead}, in \textit{The Future of the Thrift Industry}, supra note 137, at 233.
\textsuperscript{172} Id. at 233. Mr. Wall also points out that if the FSLIC “were given $30 billion additional resources, we could resolve the rest of the institutions that are currently insolvent.” Id. at 232.
under which they were created in their various home states.\textsuperscript{173}

Some states granted their state S&Ls greater powers than those granted to their federal cousins. These powers would have seemed to strengthen the state S&L system—for example, some state S&Ls issued variable rate mortgage loans before such powers were accorded the federal institutions.\textsuperscript{174} More often, however, the unbridled abilities given to state S&Ls seem to have led them into the problems of the 1980s.\textsuperscript{175} The House Report accompanying FIRREA stated:

In 1980, 51 percent of FSLIC-insured S&L's were still state-chartered and received their powers from their state legislatures. Coinciding with federal efforts to aid ailing thrifts, numerous state legislatures, the most significant being California, Florida, and Texas, passed far reaching provisions to aid their ailing state-chartered institutions. By 1984, more than one third of all states had granted their state-chartered thrifts investment powers beyond those permissible for federally-chartered institutions.

In addition to having greater powers, many state-chartered thrifts found a far less rigorous regulatory and supervisory environment at the state level. For example, . . . California let its thrift examination force drop dramatically during the early 1980s. . . . Texas followed the same pattern. Some of the most abusive and fraudulent activities affecting thrifts occurred in these states.

As long as the federal government was responsible for picking up the tab for a failed state-chartered thrift, there was no great incentive for many state legislatures to deny the sweeping demands for additional investment powers made by the thrift industry. The results were tragic. Seventy percent of all FSLIC expenditures during 1988 went to pay for problems created by high-risk, ill-supervised, state-chartered thrifts in California and Texas. Those same two states absorbed 54 percent of FSLIC expenditures in 1987.\textsuperscript{176}

The House Report also confirmed that "[t]he evidence is clear that it is primarily state-chartered institutions, and not federally-chartered institutions, which are responsible for the bulk of the thrift industry's

\textsuperscript{173} The FSLIC's powers over state institutions include, among others, the authority: (i) to regulate the issuance of NOW accounts, see 12 C.F.R. § 563.3-2 (1989); (ii) to set capital requirements, see 12 C.F.R. § 563.13 (1989); (iii) to regulate state institutions' power to issue securities, see 12 C.F.R. § 563.8-1 (1989); (iv) to prescribe geographic lending restrictions, see 12 C.F.R. § 563.9 (1989); (v) to promulgate rules regarding loans to one borrower, see 12 C.F.R. § 563.9-3 (1989); and (vi) to set loan-to-value ratios for real estate mortgage loans, see 12 C.F.R. § 563.9-7 (1989).

\textsuperscript{174} In 1975, six states permitted variable rate mortgages. See Statement of the Federal Home Loan Bank Board, supra note 132, at 76.

\textsuperscript{175} Senator Garn, one of the authors of the 1982 legislation that gave increased powers to the federal S&Ls has been cited as saying that his law "provided only modest deregulation for the industry, and that it was excessive deregulation at the state level that was to blame." N.Y. Times, Mar. 29, 1990, at D9, col. 2.

This evidence is difficult to reconcile with a report published on July 18, 1990 by the Northeast-Midwest Congressional Coalition, a group of United States Representatives. The Coalition stated that from 1988 through June 15, 1990 the total present value cost to the federal government of thrift bailouts was $57.5 billion, approximately half of which—i.e. $28.9 billion—involved insolvent state-chartered thrifts. In 1982, the year that the federal S&Ls received their expanded powers under the DIA and well before the crisis publicly manifested itself, there were 1747 FSLIC-insured federal S&Ls and 1634 insured state S&Ls. As of June 30, 1989, there were 1070 insured federal S&Ls and 1165 state S&Ls. The ratio of federal to state S&Ls was almost even at both times—in fact, the number of state institutions relatively increased. It is not necessary for purposes of this Article to choose between state and federal S&Ls, but we may fairly assume that the state-chartered institutions were at least a major part of the problem.

H. Inadequate Regulation

Inadequate activity on the part of both federal and state regulators is widely cited as a reason for the S&L crisis: "The lack of adequate supervision and examination of thrifts was one of the primary causes of the thrift crisis." At the federal level, the perception, and perhaps the reality, of incompetence in the Bank Board is today almost universal. Yet in reviewing the Bank Board’s activities during the late 1970s and early 1980s, the vigorous action on both the legislative and regulatory fronts is impressive. True, the Bank Board operated in the hope that the economic factors that were pressuring the S&Ls would reverse and that its various bandages would result in a healing. Early in the process, in 1978 to 1980, shutting down the thrift industry would probably have been too draco-
nian a solution. Hope was reasonable. Later, in 1986 or 1987, it was probably too late. In between there seems to have been a period when things looked grim and the Bank Board reasonably believed that the insurance fund was not large enough to take the loss. Nevertheless it is difficult to say whether the Bank Board should have announced that all was lost and that some two-thirds of the industry should be liquidated. Clearly, vast sums of money would have been saved. Equally clearly, such an announcement would have required a gutsy regulator. As we have previously noted, however, regulators are not like the rest of us; that’s why they are regulators. We rely upon their special qualifications attained through “education, training, and experience.” We may use our 20/20 hindsight without embarrassment. The regulators are supposed to recognize a problem when confronted with it.

Had interest rates dropped, the real estate market continued its success, and commercial business conditions prospered, would the accounting devices that the Bank Board used to keep the S&Ls alive now be perceived as prescient acts by imaginative regulators rather than as missteps by the short-sighted? It is difficult to know. Certainly a case can be made for that view.

It is also difficult to equate the agency that in 1983 tried to limit brokered deposits and as late as 1984 tried to limit interest rate risks in its insured institutions with the stumbler that in 1988 misled the public, thought that no tax dollars would be needed for the rescue after

183. Clearly, acts by the FHLBB—such as the institution of RAP—designed to steer the founders the S&Ls through their crises are now being used by the critics to fault the FHLBB for inadequate regulation. For example, see the Testimony of Sherry Ettleson, Staff Attorney, Public Citizen’s Congress Watch Before the Senate Comm. on Banking, Housing, and Urban Affairs, at 9-10 (April 18, 1990).
185. See N.Y. Times, Nov. 14, 1988, at D1, col. 6 (“The problem is that the Government is trying to keep many of the institutions alive, and it will cost more than to liquidate them, said Lowell L. Bryan, a director of McKinsey and head of its North American banking practice.”); accord N.Y. Times, Nov. 11, 1988, at D1, col. 2 (statement of Kenneth A. Guenther, executive vice president of the Independent Bankers Association).
186. The Bank Board apparently considered itself stuck. A chairman at that time later stated that “[t]here was nothing we could do. It seemed to us that it might be a cyclical phenomenon, and there might be some recovery.” Questions and Answers on “The Thrift Industry Crisis of the 1980s: What Went Wrong?”, in The Future of the Thrift Industry, supra note 137, at 62 (statement of Mr. Pratt).
187. See supra note 72 and accompanying text.
188. See supra notes 111-136 and accompanying text.
189. Even today, FDIC Chairman Seidman is considering a plan to nurse sick thrifts back to health rather than to take them over in accordance with administration policy. He cites as indicative of the benefits of such action the experience in New York State where a sick savings industry was in fact brought back to health with the assistance of compassionate regulators. See Nash, Policy Shift on Bailouts is Explored, N.Y. Times, Feb. 1, 1990, at D1, col. 6.
191. See N.Y. Times, Dec. 18, 1988, § 3, at 2, col. 4; see also N.Y. Times, Dec. 28,
the administration had conceded that "taxpayers' money is needed to deal with the savings and loan crisis,"\textsuperscript{193} that seemed to think, as late as November 30, 1988, that things were under control,\textsuperscript{194} and that ascribed a monumental failure to act to disagreements between the agency's home and its field offices and fear of a lawsuit.\textsuperscript{195} One also does not know the extent to which the Bank Board wilted under the pressure of five bribed senators.\textsuperscript{196}

The Bank Board, together with the Administration, has also been criticized for insufficient staffing.\textsuperscript{197} State regulatory agencies also "reduced the size of their examination staffs and the frequency of thrift supervision."\textsuperscript{198}

The chairmanship of the Bank Board changed during the time under study. Whether one chairman is less competent than another and therefore more responsible for Bank Board misbehavior is not particularly relevant to this Article. It is my belief that the Bank Board's place in the S&L crisis has not yet fully been revealed.

V. WHY THE S&Ls FAILED

We may still be too close to the S&L crisis to understand why it occurred.\textsuperscript{199} Volumes of material have been devoted to this question, from

\textsuperscript{194} See N.Y. Times, Nov. 30, 1988, at D2, col. 5 ("Mr. Wall attributed the partial stemming of losses in the recent quarter to the more than 140 closings and forced mergers of insolvent associations so far this year. The board hopes to handle 200 of these transactions by the end of the year . . . .").
\textsuperscript{196} See N.Y. Times, Nov. 13, 1989, at A14, col. 5; see also Questions and Answers on "The Thrift Industry Crisis of the 1980s: What Went Wrong?", in The Future of the Thrift Industry, supra note 137, at 62 (statement of Mr. Pratt that "Congress played a major role in forbearance").
\textsuperscript{199} Many conclusory statements have been offered to explain the reasons. See, e.g., Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, 101ST CONG., 2D Sess. 106-67 (Apr. 18, 1990) (A representative of Ralph Nader's Public Citizen's Congress Watch stated that "[t]he savings and loan industry's successful push for expanded investment powers was in large measure responsible for the S&L crisis."); Hill, A Never Ending Story: An Introduction to the S&L Symposium, Stan. L. & Pol'y Rev. 21, 21 (Spring 1990) ("There is common agreement that the biggest mistakes leading to the thrift crises were the decisions by the Federal Home Loan Bank Board (FHLBB), from 1980 to 1989, to allow savings and loan associations to operate with little or no capital, and the FHLBB's inability to supervise these institutions as they ran amuck."); Grundfest, Lobbying into Limbo: The Political Ecology of the Savings & Loan Crisis,
hardcover books to racy articles in the popular press. Congress has established a commission to answer the question. I suggest, as others have before me, that the cause was a combination of the factors listed in the preceding part of this Article. In evaluating the relative significance of those different factors, however, it is important to note that, over the same period that the S&L system foundered, the commercial banking system did not.

Commercial banks are, of course, conceptually similar to the thrifts: they take deposits, make loans and conduct some other financial activities. Since the creation of the federal S&L system in 1933 and through its evolution into the early 1980s, commercial banks had much greater authority to engage in various aspects of the financial business than did thrifts. While often perceived as first cousins to the thrift industry, commercial banks could diversify their activities to gain a level of protection denied the thrifts. The commercial banks' application of portfolio theory decreed that if loan $X$ became unprofitable, loan $Y$ might take up the slack; loan $Z$ was also available if both $X$ and $Y$ faltered. S&Ls, limited to loan $A$, never recovered when loan $A$ lost its profitability. Indeed, it was the quest for portfolio theory protection—to become more like banks—that led thrift regulators to sponsor and support the broadening of their powers in the critical 1980 and 1982 laws.

Commercial banks are not without problems and have had their failures, but they have been in a different league from the S&L experi-

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202. See, e.g., Grundfest, supra note 199, at 32 (calling the commercial banking industry's problems "hauntingly reminiscent of the difficulties faced by the savings and loan industry in the early 1980s"); Nash, F.D.I.C.'s Chairman Expects 1990 Loss on Bank Insurance, N.Y. Times, Aug. 1, 1990, at A1, col. 6 (reporting the FDIC chairman's announcement that the FDIC bank insurance fund would likely experience its third annual
ence. In 1989, it was announced that commercial banks experienced more failures than in any year since the Great Depression. A summary look at the numbers shows us, however, that although 206 banks failed in 1989, 192 new banks were created. This should be related to the roughly 14,000 commercial banks in existence. Problems do exist in the commercial bank system. They are, however, far from disaster proportions. It is increasingly apparent that the Federal Deposit Insurance fund is probably at risk. This is, however, a political rather than an economic problem. The question is how many bank failures may be dealt with through the accounting entry called the fund and how many will require taxpayer assistance. We note that the General Accounting Office ("GAO") has reported that thirty-five banks are in "severe financial condition." Their loss is anticipated by the GAO to deplete between $4 and $6 billion of the $13.2 billion fund.

In contrast, the S&Ls lost some two-thirds of their number. Their industry is virtually depleted; exhaustion of the thrift insurance fund is hardly their problem. The continuing suggestion that the thrifts might have to be absorbed by the commercial banking industry for their own protection is indirect testimony to the underlying health of that industry.

One may still assert that the commercial banks are nearing a state of crisis. The indisputable fact remains, however, that although a series of events has already destroyed the thrift industry, the commercial banking industry has survived relatively unscathed. For the purposes of this Article, it is enough to accept this.

One key to understanding the S&L crisis is to compare the S&L experience to that of commercial banks. Significantly, most of the specific problems listed above fell upon thrift and commercial bank alike. Commercial bank survival in the face of the thrift collapse strongly suggests that there was something inherent in the thrift system that caused the

consecutive loss); Trigaux, supra note 153, at 1 (economist Brumbaugh claiming that the FDIC was already insolvent).

204. "Banks are not in the same mess as savings and loan institutions." The Right to Protect Banks, N.Y. Times, Aug. 18, 1990, at A24 (editorial). There are prophets of doom. Jonathan Gray, a New York bank stock analyst has been quoted as saying that "the question isn't whether there's going to be a thrift industry, but whether there's going to be a banking industry." Uphill Climb for Home Loan Bank System, Am. Banker, Aug. 27, 1990, at 17, cols. 3-4.

205. These numbers were obtained from the Federal Deposit Insurance Corporation.

206. See Bank Insurance Fund, United States General Accounting Office Report to the Congress, at 3 (Sept. 1990). Reports that the FDIC bank insurance fund is functionally insolvent are very different from the system itself being at risk. See N.Y. Times, Sept. 12, 1990, at A1. Compare this to the thrifts: "As of April 13, 1990, a total of 351 S&Ls were in RTC conservatorship or receivership. . . . Those S&Ls presently in conservatorship do not represent anywhere near all of the S&Ls for which RTC assistance will be required." Krabill, Assisted Acquisitions of Ailing S&Ls in 1990: A Critical Assessment, Banking Expansion Rep., May 7, 1990, at 9.

problems to affect the thrifts in a much more serious form than the commercial banks. One may go a step further and speculate how the thrift industry might be treated in the future to avoid new problems of this magnitude.

Where a financial problem fell upon both the thrifts and the commercial banks and was a proximate cause only of the S&L failure, we are forced to conclude that the real cause of the failure was not that problem, but rather a combination of that problem with something inherent in the thrift system itself. With that approach in mind, let us once again review the specific problems listed above.

A. Interest Rate Mismatch

Rising interest rates affected thrifts as well as commercial banks because both obtain their funds from depositors and in the open market. Because thrifts were essentially one-product businesses, however, and because that product was fixed-rate, long-term residential real estate mortgages, thrifts were denied alternative investments to increase their yields as their costs increased. Commercial banks, on the other hand, had a broad range of activities, many of them short term in nature and many with fluctuating interest rates, that allowed them to meet cost increases.

Congress and regulators recognized the thrifts' deficiencies, but nonetheless expanded their powers in 1980. Indeed, The Senate Banking Committee quite specifically observed that DIDMCA "gives Federal savings and loans the ability to compete." Thus, the blow that crushed the S&Ls was not the rise in interest rates but rather the limitations upon their power to accommodate increased costs. The commercial banks had this power. In dealing with the future of the S&L industry, this key factor must be accommodated.

B. Deposit Insurance

1. Rates and Terms

We find here, as we did for interest rate increases, that the S&Ls were affected in much the same way as were the commercial banks. Their premium rates were basically the same, but the application of that rate caused thrifts to pay more for their insurance to the FSLIC than the commercial banks paid to the FDIC. Neither depended upon the pri-

210. See Nash, Savings Agency Head Sees Insurance Limits, N.Y. Times, Nov. 4, 1988, at D2, col. 5. Ex-Bank Board and OTS chairman Wall has said on this subject: "There has always been, with a couple of years' exception, a differential of one kind or another, some of it intentional, some of it perhaps coincidental. ... FDIC insurance has always been at a lower cost." Wall, The Tasks Ahead, in The Future of the Thrift Industry, supra note 137, at 236.
vate sector or the play of the free market for risk evaluation, and it is logical to assume that the thrifts' higher premiums would impose a somewhat more restricting factor upon them than premium costs imposed upon the commercial banks. While certainly deposit insurance and its rates and terms were central to the S&L collapse, the existence of this insurance system does not explain why the S&Ls were destroyed and the commercial banks survived (assuming for the moment that they are surviving) under the same insurance system. For this explanation, we must look elsewhere.

2. Brokered Deposits

It is apparent that both commercial banks and S&Ls had the ability to accept brokered deposits upon essentially the same terms and subject to virtually identical insurance protection. As we saw above, the FDIC and the FSLIC jointly attempted to eliminate the abuses stemming from brokered deposits but were foiled in court. The conclusion is that brokered deposits are not necessarily evil; they are, after all, being handled by the commercial banks subject to the FDIC reporting requirement mentioned above. If brokered deposits create a serious problem for the S&Ls, it is because of a shortcoming in the S&L system. We can fairly surmise that S&Ls abuse the brokered deposit device because they have greater pressure for immediate profits than the commercial banks, because they have more dishonest executives than the commercial banks, because they are hungrier for funds than the commercial banks or because of some other reason related to S&L operations. We are in the process of examining this latter group of reasons.

C. Reduced Net Worth and Other Accounting Gimcracks

The reduced net worth requirement and the accounting devices that sustained ailing S&Ls were undoubtedly a result of their one product structure that in turn prevented them from adjusting to rising interest rates. Those curatives were seen by the regulators and by most of the

211. One cannot be particularly optimistic about the ability of the free market to judge bank (or presumably S&L) risk. One commentator found that "the developing [bank] problems were not identified by the market until substantial damage was done." Randall, Can the Market Evaluate Asset Quality Exposure in Banks?, New Eng. Econ. Rev. 1, 4 (July/Aug. 1989). Randall also noted that "[t]he most startling finding of this review is that it did not uncover a single case of a bank stock analyst expressing strong concerns before T1 [a measure indicating clear bank problems] about the problems that later became evident." Id. at 11; see also id. at 12 ("the rating services did no better"). Concerning bank regulators, Randall wrote that "[i]t is obvious that the supervisors failed to take sufficient action on a timely basis in many of the cases studied here . . . . However, there seems to be no inherent reason why the supervisors, with their potential for unlimited access to relevant information, could not improve their performance." Id. at 18.

212. "It was federal deposit insurance that made the thrift crisis possible." Schumer & Graham, The Unfinished Business of FIRREA, Stan. L. & Pol'y Rev. 68, 73 (1990).

213. See supra notes 159-161 and accompanying text.

214. See supra notes 157-161 and accompanying text.
industry as methods that would keep the S&Ls alive until the danger passed. To say that they were a fundamental rather than a secondary cause of the S&L crisis may diffuse the crispness of the present argument. However, I do see those devices as specialized ingredients imposed upon the S&L system and inapplicable to commercial banks. As we have seen, capital ratios were reduced in 1982 to three percent.\textsuperscript{215} By contrast, national banks were required to have, depending on their size, capital ratios between 5.5\% and 7\%.\textsuperscript{216} In 1984, the Comptroller of the Currency implied that if a national bank was less than safe the capital ratio for that bank would be increased, not decreased.\textsuperscript{217} It seems reasonable to accept these unduly low capital ratios, together with the related accounting variations, as another cause of the thrift crisis.

D. Depression in the Real Estate Market

A fall in the real estate market affected both thrifts and commercial banks. Commercial banks, while clearly hurt by the widespread reduced values and reduced profitability, survived. Thrifts did not; but the cause could not have basically been the real estate market. In 1980, when we might consider the S&L problems as coalescing, they had about eighty percent of their assets in real estate mortgage loans; the commercial banks had only fourteen percent.\textsuperscript{218} Portfolio theory enabled commercial banks to spread the loss, an opportunity denied the S&Ls.\textsuperscript{219}

E. Expanded Powers Improvidently Used

The expanded powers granted to the S&Ls in the early 1980s made them more like commercial banks. The federal S&Ls generally were given powers that still did not enable them to lend and invest as widely as the commercial banks. The state S&Ls were occasionally given some even broader powers. In general, however, there is little that the S&Ls received that was not already within the operating scope of the typical commercial bank. That the S&Ls botched their new authorities and crippled themselves in the process cannot be blamed on the powers but must be deemed to relate to a basic flaw in the S&L system. As I have already suggested, the real reason that the new powers failed was that they came

\textsuperscript{215} See supra notes 123-128 and accompanying text.
\textsuperscript{216} See Interagency Guideline of the Federal Reserve Board and the Comptroller of the Currency, 1982 Fed. Reserve Bull. 34.
\textsuperscript{217} See 49 Fed. Reg. at 34,840 (1984). In addition, when risk-based capital ideas were introduced a few years later, it was generally assumed that higher risk assets would require compensating capital in greater, not lesser, amounts. See 54 Fed. Reg. 4168 (1989); see also supra notes 120-122 and accompanying text (higher capital for riskier institutions).
\textsuperscript{218} See Statistical Abstract of the United States, 1989 (Tables 797 and 805).
\textsuperscript{219} In 1987, well after the thrifts had achieved broadened lending powers, they still had approximately 66\% of their assets in real estate mortgages, compared to 20\% for commercial banks. See Statistical Abstract for the United States 1990.
to a one-product industry too late and in an unfortunate market. The S&Ls simply could not compete in a market that was already slipping.

In a flourishing economy, the expanded banking powers granted in the 1980 and 1982 federal laws and also delivered through state legislation might indeed have signalled the salvation of the S&L system. That they did not does not mean that expanded powers are wrong. It does mean that an industry restricted to real estate mortgages cannot expand without incurring risks in the process of expansion that exceed the risks of those who are already established with the broader powers. As we are seeing, an industry restricted to real estate mortgages also probably cannot exist.

F. Internal Fraud and Mismanagement

We have previously observed that S&Ls are conceptually much like commercial banks. In evaluating S&L mismanagement and fraud, we are asked to believe that "high rollers, high flyers, riverboat gamblers, and just plain crooks" are drawn to the thrift institutions and caused their failure, but are not drawn to the commercial banks (because they did not fail). I do not wish to cast any unflattering aspersions at the commercial banks, but I find this idea difficult to swallow. My hunch is that there is probably a like number of shady operators in both camps but that the thrifts were pushed to the wall and they believed themselves forced to play dirty. In other words, it appears to me that it was not the suede shoe operators who caused the thrift failure, but rather it was a set of crushing business conditions that forced (or at least encouraged) the thrift operators to don their suede shoes for what they desperately believed to be their own salvation.

220. Gray, supra note 199, at 140.

221. It has been said that marginal characters were drawn to the S&Ls because of the low prices at which they could be bought. But honest people are also attracted by low prices. See, for example, Robb, Tisch Family Invests in 3 Banks, N.Y. Times, Sept. 1, 1990, at 27, col. 3, which reports the Tisch family buying "sizable stakes" in three commercial banks because of their low prices. Mr. Tisch is the chief executive of CBS, Inc.

There is also evidence that a disproportionate number of high rollers without S&L experience may have been attracted by the low prices. The N.Y. Times, Jan. 1, 1989 reported:

Many of the nation’s most troubled savings institutions are being rescued these days by many of the nation’s savviest and most aggressive financiers, corporate executives and takeover experts.

The savings industry’s new partners in these transactions include a former Secretary of the Treasury, a former Secretary of Commerce, the chairman of Revlon, Inc., a large real estate development company, an heir to a Texas oil fortune, one of the Big Three auto makers and some of the brightest financial wizards on Wall Street.

Many of them have had little or no experience in the banking business.


222. It has been pointed out that the low prices and the ability to do a large business with a small investment attracted the high rollers. See Lang, Licensed to Steal, The Vil-
We are not without some support for this hypothesis. In 1974, the FDIC published a booklet with the self-explanatory title, *Why 67 Insured Banks Failed—1960 to 1974*. Sixty-seven banks for fourteen years may hardly be a random sample but it does give us some information. Eighty-five percent of those banks, it is reported, failed because of “self-serving loans to the banks' management (or friends of management) coupled in some cases with bad loans from out of the banks' trading areas,” “defalcations or embezzlement by bank officials or employees” and “various manipulations by bank officials.”223 A letter by the Comptroller of the Currency, dated May 25, 1988, observed that insider abuse and fraud “had a significant effect” upon forty-eight percent of national bank failures between 1979 and 1987.224 Later, the Comptroller, once again reporting on national bank failures between 1979 and 1987, stated that “Insider abuse or fraud . . . [was] apparent in many of the failed banks, about one-third.”225 FDIC Chairman Seidman reported to the House Subcommittee on Commerce, Consumer, and Monetary Affairs in 1987 that fraud and insider abuse had increased dramatically since 1982 and that “we are seeing evidence of insider abuse and fraud in as many as one-third of the banks that fail . . . (and) outright criminal activity is a factor in nearly 15% of recent failures.”226 Finally, a recent report by the Director of the FBI indicated that it was examining suspected fraud cases at 276 failed banks as compared to 234 failed thrifts.227

G. *An Uncontrolled State System*

Excesses at the state level were undoubtedly responsible for much, perhaps most, of the S&L disaster. Legislators authorized state S&Ls to do more than they were equipped to do. Regulators failed in their responsibilities to harness ambition and greed. How do we evaluate this performance? Beginning, as it did, in the early 1980s it may be perceived as an effort—parallel to that of the federal government—to save a troubled industry. To free it of its unduly restrictive regulation was generally taken to be a positive effort enabling the S&Ls that could not survive with a cost of funds in excess of their fixed mortgage income to weather a difficult period. We raise self-righteousness to a high art if we accuse the

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227. See Klinkerman, *FBI Probing More Banks than S&Ls*, Am. Banker, Apr. 12, 1990, at 1, col. 3. Director Sessions also noted that “the pace and scope of thrift fraud investigations would increase dramatically over the next few years.” *Id*. 
legislatures of California, Florida and Texas of duplicitous behavior. Indeed, a little historical research suggests that, in passing the 1982 DIA that granted federal S&Ls greater asset powers, the Congress may have used the states as its model. The following appears in the Senate Report accompanying DIA:

The potential benefits to thrifts that can be gained by authorizing powers contained in Title III are illustrated by the experience of state-chartered savings and loan associations in Texas, which have powers in the areas of commercial and consumer lending similar to those the bill would provide to Federal associations.\(^{228}\)

When we criticize those and other sunbelt states for granting extravagant powers to their state S&Ls, to a large extent we turn the federal system on its ear. Traditionally, states are the "crucibles" or "laboratories" of legislative testing.\(^{229}\) We feel safer testing ideas at the state level where, if the ideas prove unsound, they do not sink the national ship. California, for one, was proud of its expanded S&L system and advertised it for use by others.\(^{230}\) The discretion exercised by the states in giving expanded authority to the S&Ls under their jurisdiction would seem to be well within their powers and quite consistent with our concepts of a federal system.

Furthermore, commercial banks are also subject to dual banking regulation. State banks are accorded powers different from, and frequently in excess of, the powers granted to national banks. Appendix B to a 1987 FDIC study is titled "State Banking Authority Beyond Traditional Levels" and lists the activities in the equity investment, securities, real estate and insurance fields that state banks are authorized to conduct that are prohibited to national banks.\(^{231}\) More recently, the State of Delaware excited the commercial bank community by authorizing its state banks to underwrite and sell insurance nationwide, both being powers denied to national banks. We believe that we must accept what has lately been perceived as excesses at the state level not as a fault of the state system but rather as a fault of the S&L system.

The reduction in supervisory authority in some states is, in retrospect, culpable. It accompanied, however, a similar philosophy at the federal

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\(^{229}\) Whatever its dilution in civil rights areas, there is still force in Justice Brandeis' famous dissenting statement: "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." Gay Rights Coalition v. Georgetown Univ., 536 A.2d 1, 33 n.24 (D.C. Cir. 1987) (quoting New York State Ice Co. v. Liebman, 285 U.S. 262, 311 (1932)).


level where deregulation and free enterprise were the orders of the day. Laying blame everywhere but on the Congress, the House reported:

Throughout the Reagan years, the Treasury Department and the federal bank and thrift regulatory agencies continually pressured Congress to limit government intervention in the financial services industry. In line with this philosophy, the Administration would not support an increase in the number of savings and loan examiners even though the thrift industry was going through its most significant restructuring since the Great Depression.\footnote{232}

It smacks a little of dirty pool to lay the lapse of regulatory supervision over the state associations entirely at the feet of the state regulators. While those regulators are certainly the primary supervisors of the conduct of state S&Ls, they are not the only regulators. Through FSLIC insurance, the FSLIC, a wing of the Bank Board\footnote{233} had a substantial measure of regulatory jurisdiction over state and federal S&Ls in order to reduce the federal insurance risk. The FSLIC has an almost assumed authority to issue regulations designed to prevent state as well as federal institutions from engaging in unsafe or unsound practices.\footnote{234} It can terminate insurance when an insured institution engages “in an unsafe or unsound practice.”\footnote{235} It can commence cease-and-desist proceedings.\footnote{236}

As the S&Ls, state and federal both, were tumbling downhill, the FSLIC did not perform this responsibility. The blame is not entirely on the states.

One cannot fault the states even if we accept that the larger portion of S&L bailout costs fell there. One seems to see the same effort at the state level to bring a foundering industry into health that we saw at the federal level. Powers now deemed to have been excessive probably were. But from the perspective of the early 1980s they can as easily be seen as reasonable. Once again, we are at bottom faced with an industry that experienced rising costs and, because of its limited product line, an inability to raise its prices. Caught on that hook, state as well as nation struggled to resuscitate the poor fish. All failed, but this does not mean that powers were improvidently granted by state legislatures or that the nation-state system necessarily needs revision. I will have more to say on this subject in Part VI of this Article dealing with FIRREA’s mending process.

As to the regulatory lapses at the state level, this appears much like those lapses in the Bank Board and FSLIC. Indeed, as I have just pointed out, the Bank Board through the FSLIC actually constituted a part of the state fumble. We shall address those lapses, state and federal, next.

H. Inadequate Regulation

It seems clear enough that the regulators, state and federal, allowed the S&Ls to continue operating and accumulating losses that have proven massive in amount and are now being borne by the taxpayer. While it may be said that no one else recognized the risk, we hold the regulators to a higher level of responsibility than the rest of us. There was no comparable experience in the commercial bank sector. At some point, hindsight now tells us, the thrift regulators should have blown the whistle. They did not and we must hold them as a prime cause of the S&L disaster.

Too many years ago, I had a torts professor who embellished the concept of negligence with the example of a man with an egg-shell skull who was accidentally touched by a bystander. Was his destruction the bystander's fault? The S&Ls are the unfortunate shell-heads; rate mismatches, deposit insurance inadequacies, real estate slumps, briberies etc. are the careless toucher. The real fault is with the S&L system.

Our conclusion is that the S&L industry failed for three reasons. First and foremost was a reason not generally given as a basic cause of the failure: the S&L's creation and forty-seven years of existence as a one-product industry. It is understandable that those involved today with the S&L crisis and disaster should be pointing accusing fingers at each other. The real culprit does not exist today. He existed a half century ago when national planning was the philosophy of the day and little thought was given in high places to the consequences of inconsistencies between legislated goals and the play of the market.

From the time the federal S&Ls were legislated into existence in 1933 until the expansion of their powers in 1980, they together with the state S&Ls that were increasingly forced into the same mold, were fundamentally in the business of granting only long term, fixed rate home mortgages. They did not have the benefit of "portfolio theory." When legal and market shifts, particularly the rise in interest rates, altered their business environment and invalidated the assumptions upon which they were founded, they could not protect themselves as could their cousins the commercial banks.

The second reason was a net worth (capital) standard that did not put sufficient responsibility upon the owners of the S&Ls.

237. See supra note 211 and accompanying text.

238. Whether the commercial banks were less at risk and therefore the regulators were subject to less pressure or whether a more diligent regulatory structure engendered a lower order of risk need not concern us.

239. The testimony of Donald T. Regan, described as "an architect of the Reagan Administration's deregulatory policies," before the House Banking Committee on October 1, 1990 is not inconsistent with this conclusion. See Tolchin, Regan on S&Ls: Too Many Curbs, N.Y. Times, Oct. 2, 1990, at D1, col. 3 Mr. Regan, however, stressed the geographic restrictions upon the S&Ls, basically limiting their loans to one area and thereby causing financial problems when the economy of that area weakens. See id.
The third reason was regulatory inaction. However sympathetic we may be to the plight of the regulators, they should have acted sooner.

VI. PUBLIC RECOGNITION OF THE DISASTER

As we reached the middle of the 1980s, the S&L problem became too big to hide. It was now public knowledge. The underlying method of the Bank Board for dealing with it was what is technically known as “forbearance.” It is the rough equivalent of Scarlett O’Hara’s recurring decision to “think about it tomorrow.”

Forbearance was a Bank Board/FSLIC policy adopted in the early 1980s that enabled ailing thrifts to stay open.240 The underlying rationale was hope. There was also, as we have seen, some reason for optimism. Commentators have performed sophisticated analyses241 and have concluded that, even in the 1980s when the thrift crisis had become a matter for public attention, evidence was not definitive that “the S&L industry was then at the point of imminent collapse.”242

All hope was lost by 1989, however. The Bush administration prepared a bill to finance the losses in the S&L system and to correct the problems for the future. It was introduced into Congress243 and titled The Financial Institutions Reform, Recovery and Enforcement Act of 1989244 (“FIRREA”).

FIRREA represents a sweeping revision of the nation’s banking laws and the first law to provide for any realignment of the federal regulatory agencies since the great depression. We will not attempt even to summarize its provisions other than to note that it abolished the Bank Board (including the FSLIC), amended in major respects the laws governing the FDIC and the Treasury Department, revised the powers of federal S&Ls, brought state S&Ls under federal supervision, established a new federal corporation, the Resolution Trust Corporation, to dispose of insolvent thrift institutions, and effected major revisions in the way all commercial banks and thrifts will be regulated.

We will address only the portions of FIRREA that directly affect the three problems (a one-industry business, insufficient net worth—including accounting lapses—and insufficient regulation) that I have isolated as the basic causes of the S&L collapse.

1. The one industry business. FIRREA raised the percentage of residential mortgage-related assets that an S&L must hold to be a “qualified

240. See Brewer, supra note 184, at 3. The policy of forbearance was in part made possible through advances from the Federal Home Loan Banks. This joinder in the hope of saving a failing S&L system was not the function of the Banks, which were created in 1932 to provide capital in order to finance home mortgages.
241. See F.E. Balderston, supra note 7, at 37, 75.
242. Id. at 37.
243. Introduced in the House on Feb. 22, 1989 as H.R. 1278 and in the Senate the same day as S. 413.
thrift lender” (“QTL”) from sixty percent to seventy percent.\textsuperscript{245} Essentially, the QTL test ensures that a thrift institution retain its mortgage-related character by establishing a percentage of an institution’s assets that must be in loans for residential housing or for purposes closely related thereto.\textsuperscript{246} Under the pre-FIRREA approach, if an S&L is not a QTL (i) it is limited in its ability to borrow from a Federal Home Loan Bank\textsuperscript{247} and (ii) if it is a subsidiary of a holding company, that holding company’s other permissible businesses are highly restricted.\textsuperscript{248}

Under FIRREA, a thrift that is not a QTL has greater restrictions:\textsuperscript{249}

A. Its new activities and investments are limited to those permitted to national banks.
B. It may branch only as permitted to national banks.\textsuperscript{250}
C. It may not borrow at all from a Federal Home Loan Bank.
D. It may only pay dividends allowed to a national bank.
E. After three years, it must relinquish all investments and cease activities not permitted to both national banks and thrifts.
F. After three years, it must repay advances previously obtained from Federal Home Loan Banks.

The theory behind these new restrictions is that, by not being a QTL, the S&L becomes more like a commercial bank. It must, therefore, conform more to commercial bank regulation.

Most important for present purposes, however, is that before FIRREA an S&L was required to hold sixty percent of its assets in the defined residential real estate categories; FIRREA raises the percentage to seventy percent. The S&L industry—hurt by its restriction to one business—is now subject to a restriction that is greater than it had been before the “correction.” We may note by way of significant contrast to the additional restriction on S&L activities, heavy pressure now being exerted on Congress by the commercial bank regulators to increase the powers of their banks in order to increase both their profitability and

\textsuperscript{245} FIRREA’s revisions are at § 303 and are now codified at 12 U.S.C. § 1467a(m)(1) (West Supp. 1991) (amendment effective July 1, 1991). This provision was originally enacted by the Competitive Equality in Banking Act, Pub. L. No. 100-86, 101 Stat. 552, § 104(c) (1987), and interpreted by the Bank Board at 12 C.F.R. § 583.17 (1989).
\textsuperscript{246} Related loans include those made for the purchase of churches and schools, and unsecured loans, up to five percent of an institution’s assets, for personal, family, household or educational purposes.
\textsuperscript{247} See 12 C.F.R. § 521.1(b) (1989).
\textsuperscript{248} See 12 C.F.R. § 584.2a (1989).
\textsuperscript{250} National banks are limited to the branching restrictions of the McFadden Act, 12 U.S.C. § 36(e), which does not permit a national bank to branch across a state line. See Independent Bankers Ass’n of Am. v. Smith, 534 F.2d 921, 954 (D.C. Cir. 1976). Federal savings and loan associations may, with the approval of the OTS, branch across state lines. See North Arlington Nat’l Bank v. Kearny Fed. Sav. & Loan Ass’n, 187 F.2d 564, 567 (3d Cir. 1951).
We may reasonably wonder why the underpinnings of portfolio theory have their place in the commercial banking structure but not for S&Ls. Clearly, all other things being equal, the increased limitation on S&L powers represents a step in the wrong direction. All other things are, however, rarely equal.

The late expansion of thrift powers (for federal S&Ls, DIDMCA in 1980 and DIA in 1982; for state S&Ls, state legislation around those times) coupled with simultaneous business downturns made their entry into new markets inopportune. In view of that fact and because business and real estate have not recovered their vigor, a modest restriction (10 percent seems modest) in the non-residential-mortgage abilities of S&Ls in the interest of building their strength does seem reasonable. This would not, however, be a permanent part of the S&L scene. A long-term restriction of the S&L industry to residential real estate mortgages appears to be an invitation to a future calamity similar to that being experienced now. One cannot predict how the removal of the industry from free market discipline and portfolio theory will affect it in years to come, but our experience illustrates the danger. We cannot anticipate the dislocations that the assumptions we see as appropriate now may experience. This, of course, is one fundamental risk of the planned economy.

Other qualities—particularly the ability to offer variable rate instruments and the freedom from usury laws—do give the “one product” a considerable variation that had not been present in the 1970s. The perceived risk would seem to be of a lower order. Nevertheless, the beneficial goals of the 1980 and 1982 statutes should be sought once again and thrifts should be accorded the ability to operate in a free (or freer) market. We risk returning to the controlled business created in 1933. Such a business can operate with great success as long as the express and implied assumptions underlying the controls continue in place. When they dissipate, calamity follows.

I suggest a new look at the QTL test with a scheduled reduction in the percentage. Perhaps after two years the percentage should be reduced ten percent every other year. An alternative approach would be to leave the pace of change to a federal agency (probably the Treasury because OTS now resides there) with a requirement that it reach a specified percentage after a set number of years. How low it should go turns on our perception of a thrift industry. If we believe that thrifts with a focus on residential real estate loans should be a permanent part of our financial structure, 40 or 50 percent might be low enough to give the industry

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251. See Labaton, Bank Law Overhaul Proposed, N.Y. Times, Sept. 26, 1990, at D1, col. 6 (statements to Congress by FDIC Chairman Seidman and Federal Reserve Chairman Greenspan urging broader powers for commercial banks, including lessening Glass-Steagall Act restrictions that essentially keep commercial banks out of investment banking).

252. This approach was used in DIDMCA, supra note 48, §§ 202-203, 94 Stat. at 142, where it was decreed that interest rate controls on deposits shall be terminated by a committee over the course of six years.
the benefit of portfolio theory while it still retains its essential character. Whether it should indefinitely retain that essential character is beyond the scope of this Article.253

There is cause, however, to disagree with the approach taken by FIRREA to state S&Ls and the powers they may exercise. Section 222 of FIRREA amends the Federal Deposit Insurance Act by adding a new Section 28 providing in part that a state S&L, whether or not insured by the Savings Bank Insurance Fund, may not engage in any activity not permissible for a federal S&L unless the FDIC gives its approval in advance. If a state S&L impermissibly exceeds federal S&L powers, it may not be insured by the FDIC. This tends to undercut the dual banking system. It does not, however, destroy the state/federal S&L system, because the state S&L that violates the prohibition is not forbidden to operate; it is just forbidden federal insurance. This provision of FIRREA has, nevertheless, been characterized as “an unabashed effort on the part of the FDIC to force state associations to convert to a federal charter.”254

We have already seen that the unrestrained activities of state S&Ls were not an insubstantial cause of the S&L disaster; we have, however, also seen that the state system substantially paralleled the federal and that the federal regulators were delinquent in their supervision over the state S&Ls. The new FIRREA measure is penal in quality; it punishes the states for what we, in retrospect, find to have been naughty behavior. The S&L crisis should not be taken as justification for dismantling the federal system under which it is generally deemed appropriate and constructive that states have authority to assign authority to state institutions.255

For state S&Ls insured under the federal system, the federal regulators should have—and have traditionally had; I am not talking about something new—the authority to control their behavior and ensure that the insurance fund is not at undue risk.256 FIRREA retains this authority for the state commercial banks and the federal Bank Insurance Fund. In

253. It has been pointed out that “[e]very other civilized Western nation has created a separate housing lender.” Bus. Wk., Oct. 31, 1988, at 136. On the other hand “no other nation has either a huge secondary mortgage market or the glut of lenders battling for home buyers.” Id.

I am much impressed by those views that hold that we have no further need for a thrift industry. This position is sustained by the fact that commercial banks have entered the residential real estate mortgage industry in recent years to the extent that the volume of their residential real estate loans exceeds that of the thrifts. “In 1985, originations of mortgages to purchase one-to-four family dwellings, banks originated 21 percent, and other financial servicers originated 35 percent. By 1989, originations by banks were down to 39 percent. Originations by other financial servicers dropped to 27 percent. And originations by commercial banks rose to 35 percent.” Remarks by Robert L. Clarke, Comptroller of the Currency, Before the National Ass’n of Home Builders (May 19, 1990).


255. See supra notes 173-98 and accompanying text.

256. See supra note 234 and accompanying text.
substance, we are punishing the states because the federal regulators did not successfully exercise their powers over the insured state S&Ls.

Requiring a state thrift institution to obtain prior approval from a federal regulator before it may exercise a state-granted power is wrong. Commercial banks and S&Ls should in this sense be in parity: state institutions should be empowered by the states; if the institution is federally insured, the federal regulators should have supervision over its activities and the ability to prohibit or delimit those activities that appear to create undue risk. There is benefit as well as risk in state charters and state-conceived powers. FIRREA has unduly federalized the S&L system and this should be reconsidered.

2. Net Worth and Accounting. FIRREA has established a more definitive set of standards for the capital of thrift institutions than has ever been applicable to them. The standards are established in the first instance by the Director of the Office of Thrift Supervision and, as part of the expanded jurisdiction of this office, govern state as well as federal S&Ls so long as they are insured by the FDIC. While specific percentages are not mandated and the basic requirement is that the covered institution "achieve and maintain adequate capital," the Director of OTS must establish standards that "shall be no less stringent than the capital standards applicable to national banks." This reference to the capital of national banks and elsewhere to the capital of state nonmember banks is a key concept that is central to the thrift capital requirements.

Not only the basic capital standard but the qualitative factors by which those standards are reached shall be essentially alike for thrifts and national banks. Thus, the accounting variations previously adopted by the Bank Board must be dropped and thrifts must be returned to GAAP. If a thrift is in trouble, capital must be increased, not

257. See FIRREA, supra note 73, §§ 301(s) and 301(t) (to be codified at 12 U.S.C. §§ 1464(s) and 1464(t)).
258. See FIRREA, supra note 73, § 301(t)(1)(a) (to be codified at 12 U.S.C. § 1464(t)(1)(a)).
262. It is not required that the capital of the various banking institutions, including thrifts, be identical. The Office of the Comptroller of the Currency has recently submitted a report to Congress on the differences in capital requirements among the various federal regulators. See Banking Expansion Rep., Sept. 3, 1990, at 5.
Variations in treatment to meet individual hard cases are afforded to the director of OTS, but the requirement to remain comparable to national banks remains as a brake.

There are new teeth in the capital requirements. The Director of OTS must deal with insufficient capital under one of two statutory provisions. Under one, he may order increased capital. Under the other he must consider the inadequate capital as an unsafe or unsound practice.

One must believe that these new net worth standards will apply the economic precaution so fundamental to the protection of creditors, including in this case the FDIC insurance fund. It is now established by law that the owners will have a stake in every thrift’s business. If the business appears to be unduly risky, the owners will bear the loss before the insurance fund and the taxpayers are affected.

3. Insufficient Regulation. After describing the supervisory and enforcement changes effected by FIRREA, Professor Michael P. Malloy has written:

These, then, are among the principal changes introduced by FIRREA to enhance the administrative enforcement powers of the federal regulators of depository institutions. These changes embody a formidable array of expanded regulatory weapons against impermissible conduct on the part of depository institutions and institution-affiliated parties, both management participants and peripheral participants who are, for the first time, brought directly within the regulatory scheme of administrative enforcement.

Among the expansions in administrative power engineered by FIRREA are:

a. The introduction of someone called an “institution-affiliated party” over whom the FDIC has jurisdiction. An institution-affiliated party can include a lawyer or an accountant for a thrift institution.

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265. See, for example, the power of the director of OTS to use "such other methods as the Director determines to be appropriate" in amended HOLA, supra note 9, § 301(s)(1)(B), 12 U.S.C. § 1464(s)(1)(B) (West Supp. 1991), and his ability to "deviate," id. § 301(t)(2)(C), 12 U.S.C. § 1464(t)(2)(C).
270. FIRREA, supra note 73, § 204(u), 103 Stat. at 193 (to be codified at 12 U.S.C. § 1813(u)).
b. The extension of the general regulatory authority of the OTS over state in addition to federal S&Ls.\textsuperscript{271}

c. A director or officer of an insured S&L may be found liable by the FDIC for gross negligence in addition to intentionally tortious conduct.\textsuperscript{272}

d. The cease and desist powers of the FDIC, its ability to order restitution\textsuperscript{273} and monetary penalties\textsuperscript{274} have all been increased.

e. OTS is to prescribe uniform accounting and disclosure standards for all federal and state S&Ls to apply to all applicable regulations.\textsuperscript{275}

f. The FDIC is now given specific authority to determine by order or regulation that any specific activity by an insured institution poses a threat to the insurance fund.\textsuperscript{276}

The various extensions of authority will be useful only if they are exercised in an effective manner. The expansion of federal regulatory authority is a Congressional activity that has existed for S&Ls since creation of the federal system in 1933. One wonders if the Bank Board and its subdivision the FSLIC did not throughout the period we are considering already have enough authority to act more forcefully than they did based on the information available to them. Did they suffer from a lack of statutory authority or a shortage of the "education, training, and experience"\textsuperscript{277} that is fundamental to the regulatory process? If the latter, will a transfer of function from the Bank Board to the FDIC or a collection of new powers solve the problem? Or were the federal regulators, as I strongly suspect they were, well aware of all that was happening but prevented by circumstances such as a shortage of money in the insurance fund, a dedication to the survival of the industry that they regulated or pressures from bribed Congressmen (we have discussed these things above) from taking action? Did Iris Murdoch say it all? "Well, if it's human beings it's all accident, maybe good comes, maybe bad, maybe nothing."\textsuperscript{278}

\section*{Conclusion}

We arrive at an unanticipated place. It turns out that what we really have been dealing with is the benefit of a planned as contrasted with a

\textsuperscript{271} See id. § 301(4)(a)(1), 103 Stat. at 280 (to be codified at 12 U.S.C. § 1463).

\textsuperscript{272} See id. § 212(k), 103 Stat. at 243 (amending 12 U.S.C. § 1212(k)). On this subject, see generally Shea, supra note 269 (discussion of extended tort liability of S&L officers and directors).

\textsuperscript{273} See FIRREA, supra note 73, § 902, 103 Stat. at 450 (to be codified at 12 U.S.C. § 1818(b)).

\textsuperscript{274} See id. § 907, 103 Stat. at 462 (to be codified at 12 U.S.C. § 1818(i)).

\textsuperscript{275} See Amended HOLA, supra note 9, § 4(b)(1), 12 U.S.C § 1463(b)(1) (West Supp. 1991).

\textsuperscript{276} See FIRREA, supra note 73, § 221(m)(3)(A), 103 Stat. at 268 (to be codified at 12 U.S.C. § 1828).

\textsuperscript{277} See supra note 72.

\textsuperscript{278} I. Murdoch, The Message to the Planet 437 (1989).
free market system. We have seen both in action. In the 1920s, the home market was uncontrolled; it crashed in 1929 and was controlled by government in the 1930s. In the 1970s the controls didn't work and they destructed. In 1989 we witnessed the return of greater central planning. Our conclusion seems to be moderation in both directions. Reliance on either extreme will lead to trouble. Now—a time when greater centralized planning seems to be the obvious answer to the S&L crisis—may well be the time to start a return towards the free market for S&L operations.