

Savings and Loan crisis

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The **Savings and Loan crisis** of the 1980s was a wave of savings and loan association failures in the United States in which over 1,000 savings and loan institutions failed in "the largest and costliest venture in public misfeasance, malfeasance and larceny of all time."^[1] The ultimate cost of the crisis is estimated to have totaled around USD\$150 billion, about \$125 billion of which was consequently and directly subsidized by the U.S. government, which contributed to the large budget deficits of the early 1990s. The concomitant slowdown in the finance industry and the real estate market may have been a contributing cause of the 1990-1991 economic recession.

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Background

Savings and loan institutions (also known as S&Ls or thrifts) have existed since the 1800s. They originally served as community-based institutions for savings and mortgages. In the United States, S&Ls were tightly regulated until the 1980s. For example, there was a ceiling on the interest rates they could offer to depositors.

In the late 1970s, many banks, but particularly S&Ls, were experiencing a significant outflow of low-rate deposits, as interest rates were driven up by Federal Reserve actions to restrict the money supply, a move Federal Reserve Chairman Paul Volcker instituted to wring inflation out of the economy, and as depositors moved their money to the new high-interest money-market funds. At the same time, the institutions had much of their money tied up in long-term mortgage loans that were written at fixed interest rates, and with market rates rising, were worth far less than face value. That is, in order to sell a 5% mortgage to pay requests from depositors for their funds in a market asking 10%, a savings and loan would have to discount their asking price. This meant that the value of these loans, which were the institution's assets, was less than the deposits used to make them and the savings and loan's net worth was being eroded.

Under financial institution regulation which had its roots in the Depression era, federally chartered S&Ls were only allowed to make a narrowly limited range of loan types. Late in the administration of president Jimmy Carter, this range was expanded when the Federal Home Loan Bank Board eased up on some of its restrictions pertaining to S&Ls, specifically to try to remedy the impact rising interest rates were having on S&L net worth. And it was the status of an institution's net worth that could trigger a requirement that the Federal Home Loan Bank declare an S&L insolvent and take it over for liquidation. Also in 1980, Congress raised the limits on deposit insurance from \$40,000 to \$100,000 per account. This was significant because a failed S&L by definition had a negative net worth and thus would likely not be able to pay off depositors in full from its loans. Increasing FDIC coverage also permitted managers to take more risk to try to work their way out of insolvency so that the government would not have to take over an institution. With that

goal in mind, early in the Reagan administration, the deregulation of federally chartered S&Ls accelerated rapidly (see the Garn - St Germain Depository Institutions Act of 1982), putting them on a more equal footing with commercial banks. S&Ls could now pay higher market rates for deposits, borrow money from the Federal Reserve, make commercial loans, and issue credit cards. They were also allowed to take an ownership position in the real estate and other projects to which they made loans and they began to rely on brokered funds to a considerable extent. This was a departure from their original mission of providing savings and mortgages.

Deregulation and other causes

Although the deregulation of S&Ls gave them many of the capabilities of banks, it did not bring them under the same regulations as banks. First, thrifts could choose to be under either a state or a federal charter. Immediately after deregulation of the federally chartered thrifts, the state-chartered thrifts rushed to become federally chartered, because of the advantages associated with a federal charter. In response, states (notably, California and Texas) changed their regulations so that they would be similar to the federal regulations. States changed their regulations because state regulators were paid by the thrifts they regulated, and they didn't want to lose that money. This is similar to the concept of a race to the bottom.

In an effort to take advantage of the real estate boom (outstanding US mortgage loans: 1950 \$55bn; 1976 \$700bn; 1980 \$1.2tn) and high interest rates of the early 1980s, many S&Ls lent far more money than was prudent, and to risky ventures which many S&Ls were not qualified to assess. Whereas insolvent banks in the United States were typically detected and shut down quickly by bank regulators, the Congress and the Reagan Administration sought to change regulatory rules so S&L's would not have to acknowledge insolvency and the FHLB would not have to close them down.

One of the most important contributors to the problem was deposit brokerage. Deposit brokers, somewhat like stockbrokers, are paid a commission by the customer to find the best certificate of deposit (CD) rates and place their customers' money in those CDs. These CDs, however, are usually short-term \$100,000.00 CDs. Previously banks and thrifts could only have five percent of their deposits be brokered deposits; the race to the bottom caused this limit to be lifted. A small one-branch thrift could then attract a large number of deposits simply by offering the highest rate. In order to make money off this expensive money, it had to lend at even higher rates, meaning that it had to make more risky investments. This system was made even more damaging when certain deposit brokers instituted a scam known as "linked financing." In "linked financing" a deposit broker would approach a thrift and say that they would steer a large amount of deposits to that thrift if the thrift would loan certain people money (the people however were paid a fee to apply for the loans and told to give the loan proceeds to the deposit broker). This caused the thrifts to be tricked into taking on bad loans. Michael Milken of Drexel, Burnham and Lambert packaged brokered funds for several savings and loans on the condition that the institutions would invest in the junk bonds of his clients.

Another factor was the efforts of the federal government to wring inflation out of the economy, marked by Paul Volcker's speech of October 6, 1979, with a series of rises in short-term interest. This led to increases in the short-term cost of funding to be higher than the return on portfolios of mortgage loans, a large proportion of which may have been fixed rate mortgages (a problem that is known as an asset-liability mismatch). Zvi Bodie, professor of finance and economics at Boston University School of Management, writing in the St. Louis Federal Reserve *Review* wrote that "asset-liability mismatch was a principal cause of the Savings and Loan Crisis." [1] (<http://research.stlouisfed.org/publications/review/06/07/Bodie.pdf>)

Fallout

The damage to S&L operations led Congress to act, passing a bill in September 1981 allowing S&Ls to sell their mortgage loans and use the cash generated to seek better returns; the losses created by the sales were to be amortised over the life of the loan and any losses could also be offset against taxes paid over the preceding ten years. This all made S&Ls eager to sell their loans. The buyers - major Wall Street firms - were quick to take advantage of the S&Ls lack of expertise, buying at 60-90% of value and then transforming the loans by bundling them as, effectively, government backed bonds (by virtue of GNMA, FHLMC, or FNMA guarantees). S&Ls were one group buying these bonds, holding \$150bn by 1986, and being charged substantial fees for the transactions.

A large number of S&L customer's defaults and bankruptcies ensued, and the S&Ls that had overextended themselves were forced into insolvency proceedings themselves. In 1980 there were 4002 S&Ls trading, by 1983 962 of them had collapsed

For example, in March 1985, it came to public knowledge that the large Cincinnati, Ohio-based *Home State Savings Bank* was about to collapse. Ohio Gov. Richard F. Celeste declared a bank holiday in the state as *Home State* depositors lined up in a "run" on the bank's branches in order to withdraw their deposits. Celeste ordered the closure of all the state's S&Ls. Only those that were able to qualify for membership in the FDIC were allowed to reopen. Claims by Ohio S&L depositors drained the state's deposit insurance funds. A similar event also took place in Maryland.

The U.S. government agency Federal Savings and Loan Insurance Corporation, which at the time insured S&L accounts in the same way the Federal Deposit Insurance Corporation insures commercial bank accounts, then had to repay all the depositors whose money was lost.

Charles Keating and Lincoln Savings

The most notorious figure in the S&L crisis was probably Charles Keating, who headed Lincoln Savings of Irvine, California. Keating was convicted of fraud, racketeering, and conspiracy in 1993, and spent four and one-half years in prison before his convictions were overturned. In a subsequent plea agreement, Keating admitted committing bankruptcy fraud by extracting \$1 million from the parent corporation of Lincoln Savings while he knew the corporation would collapse within weeks. Another character that was just as instrumental in the failure of S&L's was Herman K. Beebe. He was a convicted felon and Mafia associate. He had many connections to the intelligence community and was considered godfather of the dirty Texas S&Ls. He initially started his career in the insurance business and eventually banking, specifically; Savings and Loan Banks. Herman Beebe played a key role in the Savings and Loan scandals. Houston Post reporter Pete Brewton linked Beebe to a dozen failed S & L's. Altogether, Herman Beebe controlled, directly or indirectly, at least 55 banks and 29 S & L's in eight states. What is particularly interesting about Beebe's participation in these banks and savings and loans is his unique background. Herman Beebe had served nine months in federal prison for bank fraud and had impeccable credentials as a financier for New Orleans-based organized crime figures, including Vincent and Carlos Marcello.

Keating's attempts to escape regulatory sanctions led to the Keating five political scandal, in which five U.S. senators were implicated in an influence-peddling scheme to assist Keating. Three of those senators — Alan Cranston, Don Riegle, and Dennis DeConcini — found their political careers cut short as a result. Two others — John Glenn and John McCain — were exonerated of all charges and escaped relatively unscathed.

Neil Bush and Silverado Savings and Loan

Neil Bush was director of Silverado Savings and Loan when the institution collapsed in 1988, costing taxpayers \$1.6 billion. Neil Bush was accused of giving himself a loan from Silverado with the cooperation of Ken Good, of Good

International, although Bush stated it was not a conflict of interest.

Reform legislation

The Federal Home Loan Bank Board reported in 1988 that fraud and insider abuse were the worst aggravating factors in the wave of S&L failures.

In 1989 Congress passed the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA) and set up the Resolution Trust Corporation to liquidate assets of failed Savings and Loans.

See also

- Fractional-reserve banking
- Tax Reform Act of 1986
- *Cottage Savings Association v. Commissioner*, a United States Supreme Court case dealing with the tax consequences of the S&L crisis
- Fred Dalton Thompson, lobbyist for the Tennessee Savings and Loan League

External links

- FDIC: The S&L Crisis: A Chrono-Bibliography (<http://www.fdic.gov/bank/historical/s&l/>)
- The Cost of Savings & Loan Crisis: Truth & Consequences (http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf)
- Classic Financial and Corporate Scandals (<http://www.ex.ac.uk/~RDavies/arian/scandals/classic2.html#thrifts>)

References

- *Inside Job*, by Steven Pizzo, Mary Fricker, and Paul Muolo. ISBN 0-07-050230-7
- "The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation," by Lawrence White(1991)
- "High Rollers: Inside the Savings and Loan Debacle" by Michael Lowy(1991)
- *United States v. Winstar Corp.*, 518 U.S. 839(1996), a US Supreme Court case to be found on FindLaw.com that gives a concise but useful history of the crisis and the accounting practices that aggravated that crisis.

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