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The Savings and Loan Debacle Twenty-Five Years Later: a Misesian Re-Examination and Final Closing of the Book

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ABSTRACT: August 9, 2014 marks the twenty-fifth anniversary of the signing into law of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 by U.S. President George Herbert Walker Bush. FIRREA was enacted to clean up the savings and loan (S&L) financial debacle of the 1980s. In articles, books, symposia, and papers written in the wake of the debacle, popular media and mainstream financial economists each provided explanations of the debacle. This paper analyzes and rejects these explanations in favor of an alternative based on Ludwig von Mises's observation that market interventions create unintended consequences that usually lead to more interventions that in turn create new waves of unintended and worsening consequences until no more interventions are possible.

KEYWORDS: bank regulation, S&L, FIRREA, deregulation

JEL CLASSIFICATION: B53, E65, G18, G21, G28

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INTRODUCTION

August 9, 2014 marks twenty-five years since the U.S. savings and loan (S&L) industry bailout in the form of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 which was signed into law by the forty-first president of the United States, George Herbert Walker Bush. After more than twenty-five years of reflection, one might reasonably conclude that the causes of the S&L debacle would be a more settled issue among economists, but unfortunately they are not.

Twenty-five years after the industry bailout, the causes of the debacle are still important because first, at the time of its occurrence, the collapse involved the second largest number of failed financial intermediaries in U.S. history.[1] Precise and rigorous understanding of the causes of such a large number of financial-intermediary failures could have helped prevent the financial collapse of 2008. Second, because the collapse of 2008 was not averted, perhaps returning to the drawing board in a sincere effort to learn the lessons of 1989 (and 2008) could prevent a future financial collapse of similar or greater magnitude. Third, the S&L debacle serves as yet another case study of the unintended consequences of legislation and regulatory policies and how more legislation and regulation as the usual solutions to these unintended consequences can make economic conditions not better but even worse.

The following sections will first explore the causes of the crisis as adduced by popular and scholarly literature at the time of the debacle. Why include popular media? One discouraging finding was that some scholars, including some prominent names, seemed to uncritically parrot the simplistic explanations of the debacle posited by non-economist reporters, journalists, and political leaders.

Next, after dispelling mainstream explanations, the history of the S&L industry will be briefly explored. An alternative explanation will be proposed that is based on Mises's observation of how markets and industries can become dysfunctional from one control after another being imposed in succession. In the middle of this chain of causes of market collapse will be an examination of the

[1] The first being the permanent closure of over 6,000 banking institutions between 1929–1933 during the Great Depression (Flynn 1998, p. 29).

catalytic role a coalition of special interests played in successfully lobbying for public policies that changed the structure of the S&L industry. This new industry structure, which proved to be unstable, was the major cause of the debacle.

POPULAR MEDIA THEORY

Newspaper and magazine articles as well as books produced for mass audiences understandably had the greatest effect on how ordinary Americans viewed the S&L debacle. Normally, the popular-media perspective of an economic collapse should be of little significance in an academic study. Unfortunately, the media conception of the debacle appeared to influence some scholarly perspectives, and to fully understand those perspectives, it is necessary to understand what lay behind them.

According to popular media, the S&L debacle began around 1988 after a series of sensationally reported S&L failures around the nation and before President George Herbert Walker Bush announced a plan for restoring the health of the S&L industry on February 6, 1989. After Bush's proposal, dozens of newspaper and magazine articles, television news reports, and popular books about the debacle appeared.

One of the first and unquestionably most influential was *Inside Job: The Looting of America's Savings and Loans* (1989) by the journalists Stephen Pizzo, Mary Fricker, and Paul Muolo (PF&M). Although first begun in 1983 as a series of newspaper articles, the book made its timely appearance in 1989 when Congress was debating the passage of FIRREA. *Inside Job* came to be widely cited in articles and books written during and after 1989.

Inside Job placed the blame for the debacle on fraud facilitated by Reagan-era deregulation. The book's introduction "Original Sin" begins with President Ronald Reagan in the Rose Garden of the White House signing the Garn-St. Germain Act of 1982 and proclaiming the bill "a jackpot." The scene then abruptly switches to a March 1986 orgy in a penthouse suite at the Dunes Hotel and Casino in Las Vegas hosted by Ed McBirney, the chairman of Sunbelt Savings and Loan of Dallas. Four months after the orgy McBirney was forced to resign after it was discovered that Sunbelt was suffering losses of about $500 million (Pizzo, Fricker, and Muolo, 1989, p. 2). PF&M are eager to draw a connection between the supposed deregulation "jackpot" and fraud perpetrated by individuals in the industry with the implication that fraud was the principal downfall of the industry.

The partisan nature of PF&M's treatment becomes evident in a perusal of the book's index. U.S. President Ronald Reagan is cited twelve separate times throughout the book but Reagan's predecessor James E. Carter, Jr. is not mentioned at all. This is odd because Carter signed into law the first of the two 1980s deregulations of financial intermediaries, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980.

Table 1 below is a time line of modern industrial deregulation published in 1985. It begins in 1976 during U.S. president Gerald R. Ford, Jr.'s administration with the deregulation of railroads. The next four initiatives were signed into law by Ford's successor James E. Carter, Jr. Reagan was only responsible for signing into law the bus and banking deregulations of 1982.

Table 1. Deregulation: Legislative Milestones

Act	Year	Key Elements
Railroad Revitalization and Regulatory Reform Act	1976	Allowed railroads limited rate setting autonomy; was the first piece of deregulation legislation in the recent wave
Airline Deregulation Act	1978	Instructed the Civil Aeronautics Board to place maximum reliance on competition in its regulation of passenger service; provided that the board's authority over domestic fares and mergers would end Jan 1, 1983 and that the C.A.B. would be abolished Jan. 1, 1985
Staggers Rail Act	1980	Limited the Interstate Commerce Commission's jurisdiction over rates to those markets where railroads exercised market dominance; introduced price competition
Motor Carrier Act	1980	Allowed truckers to form subsidiaries and expand into additional regional markets; ended necessity of demonstrating public need; placed fewer restrictions on certain industry hauling practices; eased entry and introduced price competition
Depository Institutions Deregulation and Monetary Control Act (DIDMCA)	1980	Allowed mutual savings banks to make commercial, corporate and business loans equal to 5 percent of their assets; allowed payment of interest on demand deposits; removed interest rate ceilings
Bus Deregulatory Reform Act	1982	Allowed companies to obtain operating authority without applying to the I.C.C. in many circumstances
Thrift Institutions Restructuring Act (Garn-St. Germain)	1982	Authorized savings and loans to make commercial loans equal to 10 percent of their assets; allowed investments in nonresidential personal property and small business investment companies

Source: *Business Economics* via Silk (1985)

Also odd is how PF&M, so single-mindedly scapegoating deregulation, do not attempt to explain why a large number of firm failures and taxpayer bailouts did not follow the deregulations of the railroad, trucking, and airline industries the way they followed the alleged deregulations of the S&L industry.

With regard to regulation, PF&M's story is inconsistent. They laud the creation of the Federal Savings and Loan Insurance Corporation (FSLIC) in 1934, strangely crediting it with ushering in "a business cycle that worked beautifully for 50 years" (p. 10). They then contradict the notion that all was well in the S&L industry until 1984 by conceding that in 1980 the net worth of the industry was –$17.5 billion[2] with 85 percent of S&Ls "losing money" (p. 11).

Undaunted, PF&M continued on with 23 chapters filled with dozens of names, dates, and tales of land flips, phony corporations, straw purchasers, and swindler networks that reached down to organized crime and up to celebrities and prominent politicians. It was riveting reading and to the untrained eye, PF&M seemed to have built an airtight case that the S&L debacle was simply the result of massive fraud facilitated by deregulation.

After PF&M's *Inside Job* came Martin Mayer's *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry* (1990). Although Mayer cited other causes than fraud, the title of his book along with entire chapters on Charles Keating, the Keating Five, Jim Wright and Danny Wall, as well as a final chapter titled "Can This Country Be Saved?" left readers with the unshakable impression that the debacle was caused by little other than fraud. Mayer's misleading book was followed by *Who Robbed America?: A Citizen's Guide to the S&L Scandal* (1990) by Michael Waldman. The introduction, written by Ralph Nader, drives home the book's thesis that the debacle was caused by "Reagan-era zealotry for sweeping deregulation" that allowed "an unprecedented frenzy of speculation and business criminality" (Waldman, 1990, p. xiii).

Next came Kathleen Day's *S&L Hell: The People and the Politics behind the $1 Trillion Savings and Loan Scandal* (1993). Day claimed in the introduction that her book did not "advance a grand theory" as to what caused the crisis and if there were lessons to learn from

[2] Niskanen (1992, p. 45) cites a Federal Home Loan Bank Board (FHLBB) report released in July 1981 that determined the industry's net worth to be "overstated by $152.3 billion, on a market-value versus book-value basis, at the end of 1980." According to Niskanen, since the book value of the industry was only $32 billion at the end of 1980, this implies that the industry's market value was –$120.3 billion. The National Commission on Financial Institution Reform, Recovery, and Enforcement (NCFIRRE) issued a report in 1993 that estimated that from 1981 to 1982, the S&L industry's market value was around –$150 billion (*Origins*, 1993, p. 1).

the debacle, she "left them for the reader to draw" (Day, 1993, p. 10). However, given that the next 378 pages of her book contained stories about deregulation and corrupt characters such as Charles Keating, Don Dixon, Jim Wright, and the Keating Five, most readers were inevitably left with the impression that deregulation-inspired fraud was the primary cause of the debacle.

MAINSTREAM ACADEMIC THEORIES

Alan Blinder

Unfortunately, instead of examining the debacle through the lens of academic objectivity, some economists were unduly influenced by the popular fraud hypothesis. One of the most prominent was Princeton University professor Alan Blinder, a former Co-Chair of the President's Council of Economic Advisers under U.S. President Bill Clinton and a former Vice Chair of the Federal Reserve System's Board of Governors. In 1991 Blinder wrote that "[t]he rash of bankruptcies in the savings and loan industry in the 1980s seemed to support those who claimed that deregulation had gone too far" (Baumol and Blinder, 1991, p. 223). In this environment of deregulation, the "industry began to be populated by financial cowboys" so that "much imprudent risk-taking and mismanagement was tolerated, and the industry was beset by an outrageous amount of fraud" (Baumol and Blinder, 1991, p. 232).

Given that data reveal that the industry was in serious financial trouble around the time of the Carter-approved deregulation of 1980 and in serious trouble two years before the Reagan-approved deregulation of 1982, the assumption that the industry was actually deregulated will now be evaluated. DIDMCA 1980 was deregulatory in the sense that it repealed Regulation Q (the interest-rate ceiling on time deposits implemented by the Banking Act of 1933). DIDMCA also authorized negotiable order of withdrawal (NOW) accounts in all federally insured institutions for individual and not-for-profit depositors. For federally chartered S&Ls the Act allowed: credit card services; a maximum investment of 20 percent of assets in a combination of consumer loans, commercial paper, and corporate bonds; real-estate loans no longer subject to geographic constraints; and acquisition, development, and construction (ADC) loans (Barth, 1991, p. 123).

However, DIDMCA's provision raising the federal deposit insurance ceiling from $40,000 to $100,000 per account clearly represented greater interference in loanable-funds markets. Other measures, in terms of reducing the level of regulation, were ambiguous at best. These included a provision allowing a maximum of 3 percent of assets of federal S&Ls to be invested in service corporations with 1 percent (of the aforementioned 3 percent) to be invested in "community or inner-city development" (Barth, 1991, p. 123).

The Garn-St. Germain Depository Institutions Act of 1982 allowed federal depository institutions to accept demand deposits of business partners. It increased the allowable percentage of asset limits of commercial loans to 10 percent, commercial leases to 10 percent, consumer loans to 30 percent, and commercial mortgages to 40 percent (Barth, 1991, p. 124). This was the Act's loosening of regulations.

The Act's new regulations included expanded "capital assistance" programs, new powers granted to the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) for treating insolvencies, and a mandate for the Depository Institutions Deregulation Committee to invent a new type of account that could adequately compete with money-market mutual funds (Barth, 1991, p. 124).

In summary, while some provisions of DIDMCA 1980 and Garn-St. Germain 1982 were truly deregulatory, other provisions in the two laws were not. Many other market controls implemented via previous laws were still in place. The federal deregulations of the airline, trucking, and railroad industries of the mid-1970s to early 1980s, while not completely and truly deregulatory as well, were much more deregulatory than DIDMCA and Garn-St. Germain. They did not precede a collapse and large federal bailout of the airline, trucking, and railroad industries.

David Colander

Another scholar with impressive credentials but shallow analysis of the debacle was David Colander. A former president of the History of Economic Thought Society and the Eastern Economics Association, Colander served as a member of the editorial boards of the *Journal of Economic Perspectives, The Journal of Economic Methodology, The Eastern Economics Journal,* and the *Journal of the History of Economic Thought*. As late as 1998 he wrote of the debacle:

> A small part of the answer is fraud—banks made loans to friends that they knew were more like gifts than loans. Part of the answer is that it doesn't take many bad loans to pull a bank under. Another part of the answer is that it isn't hard to make a bad loan. Making loans requires taking chances and, when you take chances, once in a while you lose. S&Ls bet that there would be no recession. When a recession started, they lost their bet, and a number of their loans went bad. The last part of the answer is the government guarantee. Had the government not guaranteed the S&Ls' deposits, depositors (not the government) would have incurred the loss. They likely would have become alarmed as they saw troubles coming to their S&Ls and would have withdrawn their money before the situation became a disaster. But they didn't watch carefully and had no reason to be alarmed, because they knew the government had guaranteed their deposits (at least, up to $100,000). (Colander 1998, pp. 222–223)

To assert that fraud played a "small part" in causing the debacle one has to assume that resolution costs or their sub-components signify causality. Of many sources, Ely (1993) comes closest to explaining the problem with this assumption: "[C]riminality costs the taxpayer money only when it occurs in an already insolvent S&L that the regulators had failed to close when it became insolvent. Delayed closure is the cause of the problem, and criminality is a consequence." (p. 373)

What Ely either missed or failed to clarify is that taxpayers had to indemnify fraudulent losses only if they occurred in insolvent institutions after the deposit insurance funds themselves became insolvent. If an S&L became insolvent and was disbanded, FSLIC, capitalized with industry funds for such a contingency, made sure depositor liabilities were met. It was only when the deposit insurance fund itself became insolvent, that tax revenue had to be utilized to meet depositor liabilities.

Colander is also incorrect in asserting that deposit insurance was a cause of the debacle. While it does make financial intermediaries unstable because it increases moral hazard, rational ignorance existed on the part of depositors in commercial banks, mutual-savings banks, and credit unions as well. (It also exists to a lesser extent among some mutual-fund account holders.) Commercial banks, mutual-savings banks, and credit unions were federally insured along with S&Ls but there was no similar debacle in those industries at the time.

Colander concluded:

> Some economists blame the crisis on the bank deregulation that let S&Ls make risky loans and investments. They claim the S&Ls' crisis showed the need for regulation. Others blame government guarantees that stopped the market forces from operating. As usual, both have reasonable arguments. (Colander, 1998, p. 223)

Unfortunately neither position is reasonable, complete, or coherent without a better understanding of the institutional evolution of financial intermediaries in the U.S.

Lawrence White

Lawrence J. White served on the Federal Home Loan Bank Board (FHLBB) between November 12, 1986 and August 18, 1989. He is a professor of economics at New York University and wrote a book about the debacle that was published in 1991 by Oxford University Press. In it he discussed what he believed were the causes of the debacle. Very promisingly, he began by separating causes into two categories: pre-1980s causes and 1980s causes.

Borrowing short to lend long was White's (1991) first cause of the debacle. He mentioned that the earliest time this flawed structure encountered problems was 1964–1966. With interest rates on Treasury bills increasing from 3.53 percent in January 1964 to 5.01 percent in December 1966, S&Ls saw their profits squeezed away. In September 1966 Congress passed the Interest Rate Control Act (IRCA). This law extended the Fed's 1933 Regulation Q interest-rate ceiling to the S&L industry, with S&Ls receiving a seventy-five basis point advantage over banks.[3] From 1966–1969, the ceiling on savings accounts at banks was set at 4 percent, while the ceiling at S&Ls was 4.75 percent.

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[3] Hadley's (1993) study is similar to White's. She claimed that the advantage was 25 basis points. Mayer (1990, p. 36) claimed that the initial difference was 50 basis points which was later reduced to 25. It was beyond the scope of this paper to resolve this discrepancy.

Because rates on three-month Treasury bills remained anywhere from 53–193 basis points above the S&L ceiling during this same 1966–1969 period, in 1970 the Treasury increased the minimum denomination of its bills from $1,000 to $10,000. This, as intended, made it more difficult for small depositors to escape the below-market returns of the thrift and bank industries. Adjustable-rate mortgages (ARMs) would have helped the S&L industry with its rate squeeze but federal S&Ls were not allowed to offer them until the early 1980s. State S&Ls in Wisconsin and California were allowed to offer them. The British analogue to American S&Ls, building societies, had been permitted to issue them since the 1800s.

Although White names the maturity mismatch as a problem, he does not come close to expounding what the source of the maturity mismatch was. The only time he mentions the Federal Housing Administration is to state incorrectly that it was "created in 1934 by the HOLA [Home Owners' Loan Act]" (White, 1991, p. 57).

Calavita, Pontell, and Tillman

Last of all is the analysis of Kitty Calavita, Henry N. Pontell, and Robert Tillman (CP&T) in their book *Big Money Crime: Fraud and Politics in the Savings and Loan Crisis* (1997). CP&T's study was academic because all three of its authors are professors of sociology. It was published much later and was definitely the last of the sensational crime-focused books because it was not only a spirited defense of the fraud hypothesis, but an attack on its doubters in the economics profession.

> Too often... economists and financial experts have attributed the disaster to faulty business decisions or business risks gone awry. We argue instead that *deliberate insider fraud was at the very center of the disaster*. Furthermore, we contend that systematic political collusion—not just policy error—was a critical ingredient in this unprecedented series of frauds. (Calavita, Pontell, and Tillman, 1997, p. 1, emphasis added)

CP&T attack Bert Ely's division of the September 1990 present-value costs of the debacle into components (see Table 2 below). They accuse Ely of understating fraud by using too narrow a definition. In other words, Ely's components of present-value costs overlap each other.

If CP&T are correct about overlap in Ely's categories, then only four other categories in Ely's classification can possibly overlap his fraud category. Those categories are the second, fourth, fifth, and seventh categories in Table 2 below (viz., real-estate losses; excessively-high interest rates to support risky assets; unnecessary luxuries; and junk bond, business, and personal-loan losses). Even if one hundred percent of the nominal values of these other four categories are subsumed into Ely's fraud category (which they legitimately cannot be) the total cost of fraud adds up to $67 billion. As a proportion of the $147 billion present-value total, this new fraud component ends up being 46 percent of the total taxpayer cost of the debacle. This would clearly be an overestimate of the cost of fraud to taxpayers.

Table 2. Components of the September 1990 Present Value Cost of the S&L Bailout

Component	% of Total Cost	Cause
$43,000,000,000	29%	Interest costs incurred when regulators failed to close troubled S&Ls in 1983 and instead kept them open and hid their insolvency behind accounting gimmicks.
$28,000,000,000	19%	To help S&Ls recover from earlier losses, Congress approved greater asset diversification under the Garn-St. Germain Act of 1982. Combined with FSLIC insurance this encouraged risky real-estate investments whose values declined in the late 1980s.
$25,000,000,000	17%	From 1978–1983 S&Ls got scorched by inflation when they paid skyrocketing interest rates on their deposits but continued to earn low interest rates on their long-term, fixed-rate mortgage assets.
$14,000,000,000	9.5%	Loss from offering above-market rates on deposits to fund risky assets.
$14,000,000,000	9.5%	Spending on extravagant items and unnecessary branch offices.
$12,000,000,000	8.2%	Losses from mistakes committed by regulators in liquidating insolvent S&Ls.
$6,000,000,000	4.1%	Total losses from "junk bonds," business, and personal loans.
$5,000,000,000	3.4%	Total losses from theft on the part of S&L owners and executives.
Total: $147,000,000,000	100%	

Source: Hector (1990, pp. 84–85)

While Ely's estimate of 3.4 percent seems low, other estimates are not much higher. Barth, Bartholomew, and Labich (BB&L) (see Barth, 1991, p. 44) found that according to their measures, about 10 percent of the taxpayer costs of the crisis was due to fraud. The highest estimate is provided by William Black of the Office of Thrift

Supervision (OTS) (see Barth, 1991, p. 44). Black estimates the cost of fraud at 25 percent of total resolution costs.

Irrespective of Ely, BB&L, or Black's assessments, it must again be remembered that these numbers are proportions of the costs of resolution to taxpayers, not indicators of causality. For fraud alone to cause a failure it would have to, at the margin, be the sole conduit of capital dissipation for an institution. An aggregate estimate of the number of S&Ls for which this is the case does not exist. Therefore, the fraud-as-the-single-or-partial-cause-of-industry-failure hypothesis is unproven and unprovable.

That CP&T are mistaking components of resolution costs for causes cannot be in doubt when they add what they believe to be "empirical" and "logical evidence." After reviewing the worn-out stories about Erwin Hansen, Don Dixon, and Charles Keating, they snow the reader with four and a half pages of "empirical evidence" including the number of failed S&Ls in which fraudulent activities occurred, the number of criminal referrals, percentages of institutions plagued by "serious criminal activity" (p. 28), percentages of failed S&Ls in a particular district involving fraud, percentages of criminal activity occurring in "RTC-controlled institutions" (p. 28), conviction rates, and "the resolution costs of all thrifts that the RTC suspected of criminal wrongdoing" (p. 29). Unfortunately for CP&T, not a single one of these figures or reports addresses the etiology of the debacle.

AN ALTERNATIVE EXPLANATION

"Middle-of-the-Road Policy Leads to Socialism" was an address Ludwig von Mises gave to the University Club of New York on April 18, 1950. In this address (Mises, 1980), Mises observed that political leaders usually respond to the unintended consequences of market controls with more controls. Mises used the example of a market for milk in which political leaders think prices are too high. The government sets a price ceiling which causes producers to incur losses, so the producers shut down a portion of their milk production, divert another portion of it to the still-uncontrolled butter and cheese markets, and hence a milk shortage results. The political leaders like the new lower price for milk but not the shortage. The leaders decide to address the shortage by putting a price control on the factors of production in the milk industry to lower the cost of milk production and (they hope) remedy the shortage. Dairy cows, machinery, transportation, and labor all used to produce milk have their prices fixed below equilibrium. What results is a shortage of all these factors of production for milk while the milk shortage is only slightly alleviated, if at all.

Political leaders, seeing capital and labor continually flee to still-uncontrolled industries, decide to place controls on many or most, if not all, of those industries and their production factors until the economy is overtaken by widespread dysfunction: pervasive shortages, burgeoning black markets, and capital flight, to name just a few pathologies.

Following a similar pattern, what can be seen in the history of the U.S. S&L industry again and again was the unintended consequences of control after control met with more controls.

A Brief History of the S&L Industry

According to Barth (1991, p. 9), the first official S&L was the Oxford Provident Building Association formed in Frankford, Pennsylvania on January 3, 1831. S&Ls increased in number and, except during a recession in the 1890s, were financially sound enterprises for the next 100 years (Barth 1991, p. 12). Mayer, Duesenberry, and Aliber (MD&A) (1990) place a turning point at the New Deal. Before the Great Depression, mortgages typically were 5 years in length and were paid back in full lump sum (total interest plus principal) at maturity. Although these short-term, balloon-payment mortgages were usually extended for an additional term to help borrowers pay them off, they were derided as favoring the wealthy (Mayer, Duesenberry, and Aliber, 1990, p. 94).

Although MD&A trace the beginning of the long-term, fixed-rate mortgage to the New Deal, they do not name the legislation that created it. This is where academic financial economics arrives at a dead end. However, literature in academic sociology explicating the history of public housing provides some clues.

The National Housing Act (NHA) of 1934 was the legislation that established the Federal Housing Administration (FHA). This federal agency insured mortgages made by private lenders. Jacobs et al. (1986) call the Act "one of the most important pieces of housing legislation in U.S. history" (1986, p. 7) and interpret the Act as the "response of the Roosevelt Administration and Congress to the mortgage market's structural and institutional inadequacies" (p. 7). FHA encouraged S&Ls to abandon the short-term, balloon-payment mortgage in favor of the "more affordable" long-term, fixed-rate mortgage (LTFRM) that is prevalent today (Jacobs et al. 1986, p. 7).

While progressives in Congress and the Roosevelt administration thought that a federal agency such as FHA would be effective in making "decent" housing more affordable to the public, they were also motivated by the hope that it would create much-needed jobs in a severely depressed economy. What is also clear, though, is that the proposed legislation appealed to a broad coalition of conservative business interests whose support was crucial in getting it enacted.

Special Interests

There were ten distinct private interests that testified to U.S. House and Senate committees unconditionally in favor of the bill that was passed and enacted as NHA 1934. Only one of the major private interests that testified had an ambivalent attitude toward the bill. The private interests represented were commercial banks, mutual-savings banks, S&Ls, insurance companies, real-estate firms, construction firms, labor unions, lumber dealers, brick manufacturers, and architects.

Although passions ran strongly on both sides, among the bill's advocates, emotion was the *sine qua non* of their appeal given their conspicuous lack of a coherent argument in favor of the bill. Nevertheless, the bill passed the Senate on June 16, 1934 by a vote of 71 to 12 with 13 Senators abstaining (*Congressional Record* 1934, p. 12,013). It was signed into law by President Franklin Delano Roosevelt on June 27, 1934 (*Statutes* 1934, p. 1,246). Table 3 summarizes the witnesses, their organizational affiliations, and the industry interest they represented.

Table 3. Summary of Witnesses and Interests Represented, House and Senate Committee Hearings, National Housing Act 1934

Witness	Organization	Interest Represented
Henry I. Harriman	U.S. Chamber of Commerce	Construction Firms, Small Banks
Robert V. Fleming	Riggs National Bank, Washington, D.C.	Commercial Banks
Roger Steffan	National City Bank, New York, NY	Commercial Banks
Charles A. Miller	Savings Banks and Trust Company, New York, NY	Mutual-Savings Banks
Harold Stone	Onondaga County Savings Bank, Syracuse, NY	Mutual-Savings Banks
Morton Bodfish	United States Building and Loan League, Chicago, IL	Savings and Loans
I. Friedlander	Gibraltar Savings and Building Association, Houston, TX	Savings and Loans
William H. Kingsley	Penn Mutual Life Insurance Company, Philadelphia, PA	Insurance Companies
Maco Stewart	Stewart Title Insurance Company, Galveston, TX	Insurance Companies
Hugh Potter	National Association of Real Estate Boards, Houston, TX	Real-Estate Firms
E. Avery McCarthy	California State Real Estate Associates	Real-Estate Firms
H.P. Liversidge	Philadelphia Federation of Construction Industries, Philadelphia, PA	Construction Firms
William C. O'Neill	American Federation of Labor, Washington, D.C.	Labor Unions
Wilson Compton	National Lumber Manufacturers' Association, Washington, D.C.	Lumber Dealers
Lewis P. Lewin	Lewin Lumber Company, Cincinnati, OH	Lumber Dealers
Jordan A. Pugh	Brick Manufacturers Association, Washington, D.C.	Brick Manufacturers
Edward J. Russell	Independent Practice, St. Louis, MO	Architects
Stephen F. Voorhees	Independent Practice and American Institute of Architects, New York, NY	Architects

Source: *Hearings* 1934, H.R. 9620 and S.3603

The Keystone in Place

The first crucial component of the unstable structure of the S&L industry was the long-term, fixed-rate mortgage created by NHA 1934. The second crucial component of the industry's shaky structure was the homogenization of its assets. S&Ls had been given incentives to hold dangerously undiversified asset portfolios filled with usually not much more than long-term, fixed-rate mortgages. Martin Mayer wrote that "S&Ls did little but write mortgage loans on one- to four-family housing, sometimes because their charters required it, sometimes because holding within those restrictions got them wonderful benefits under the Internal Revenue code." (1990, p. 33)

Linda Upshaw Hadley (1993) attributed the lack of S&L asset diversity to the Interest Rate Control Act (IRCA) of 1966. IRCA authorized the Federal Home Loan Bank Board (FHLBB) to establish interest-rate ceilings for S&Ls that were 25 basis points higher than those given to commercial banks under the Federal Reserve System's Regulation Q. In return for the interest-rate advantage, S&Ls were required to invest a large portion of their assets in mortgages. Hadley does not cite the specific percentage required by FHLBB under IRCA 1966 to be invested in mortgages. She, like Mayer, also names the Internal Revenue Code as a culprit.

Until elimination by the Tax Reform Act of 1986, thrifts with more than 82 percent of assets in mortgages received favorable tax treatment (Hadley, 1993, p. 17). Regardless of the sources of the incentive to carry a large percentage of assets in long-term mortgages, the combined incentives were successful. Hadley (citing Kaufman, 1992) states that before the movement to deregulate S&Ls, mortgages comprised an average of over 82 percent of S&L asset portfolios throughout the industry.

The Postwar S&L Industry 1945–1960

The golden years of the S&L industry in the twentieth century were undoubtedly after World War II, when the economy reverted to peacetime production. The process of suburbanization followed and S&Ls, given their protected turf in home lending, assumed a prominent position in many communities throughout the nation.

Pizzo, Fricker, and Muolo (1989) portray the 1947–1960 expansion as an idyllic era for the thrift industry. The industry was supposedly populated by managers such as George Bailey, the character played by the actor Jimmy Stewart in the 1947 movie *It's a Wonderful Life*. These Ward and June Cleaver years were the era of the 3–6–3 rule: "…savings and loan executives borrowed (from depositors) at 3 percent, loaned (to homebuyers) at 6 percent, and were in a golf cart by 3 p.m." (Pizzo, Fricker, and Muolo, 1989, p. 10)

Martin Mayer punctures this confabulation with the observation that

> [d]espite its lovely reputation... the old fashioned S&L was a nest of conflicting interests that squawked for sustenance from the customers' deals. On its board were the builder, the appraiser, the real estate broker, the lawyer, the title insurance company, and the casualty insurance company. (Also the accountant: One mutual S&L in Ohio that lost virtually all of its depositors' money was audited by an accountant who sat on the board, and nobody thought there was anything wrong with that.) Plus there was somebody from the dominant political party and from one of the churches. Many little mouths to feed. It is not unfair to say that nobody controlled what this board did. (Mayer, 1990, p. 29)

Regardless of the actual venality found inside some S&Ls, the industry lived in a relatively smooth environment until the mid-1960s when quickly rising short-term interest rates began to adversely affect the rigidly structured industry. The slight rise in interest rates in the two decades after World War II did not pose that much a problem to S&Ls. The interest rate on ten-year T-bonds was 2.8 percent in 1953 and 4 percent by 1963. The term structure of interest rates did not change at all during this time period. The years between 1965 and 1982, however, were a different story. In 1982 the rate on T-bills was 14 percent and the rate on ten-year T-bonds was 13.9 percent (Mayer, Duesenberry, and Aliber, 1990, p. 94). Not only had rates risen dramatically, but the yield curve had inverted as well.

The Turbulent 1970s

Regulation Q had been used since 1933 to limit the interest rates paid on deposits at commercial banks. Whenever market interest rates reached or exceeded the ceiling, the Fed gave banks some latitude in adjusting to them. This changed after the passage of

IRCA 1966 when the Fed, at the behest of FHLBB, took the unprecedented step of lowering the ceiling to reduce pressure on thrifts who were experiencing disintermediation to banks because banks were able to pay higher rates on their deposits (Mayer, Duesenberry, and Aliber, 1990, pp. 94–95).

Disintermediation, though slowed somewhat, did not stop. Wealthy depositors earned higher rates of return by withdrawing their funds from both banks and S&Ls and purchasing Treasury securities. Large or long-term deposits flowed out of thrifts toward higher returns. This forced S&Ls to cut back on lending, creating the opposite effect for which the imposition of Regulation Q was intended (Mayer, Duesenberry, and Aliber, 1990, p. 95).

S&Ls tried to remedy this by allowing either large or long-term accounts to earn a higher return than small, short-term accounts. This measure failed because it substituted one type of account shifting for another. Instead of large and long-term deposits moving out of thrifts to government securities, small depositors combined accounts and changed their status to long term. This brought the problem back to square one (Mayer, Duesenberry, and Aliber, 1990, p. 96).

Another phenomenon was non-price competition. Barred from competing on the basis of interest rates, banks and thrifts offered depositors flashlights, toasters, clock radios, coupons, and gift certificates for opening new accounts. Apart from the competition in "free" gifts, a convenience competition arose where superfluous bank and thrift branches were built in a multitude of locations in cities in the interest of satisfying customers' demands for convenience (Mayer, Duesenberry, and Aliber, 1990, p. 95). The offering of free gifts and branches on every other street corner went only so far in helping banks and thrifts keep customers. The introduction of the money market mutual fund in October 1972 by Merrill Lynch allowed small savers to reap the same returns as wealthy savers. No longer forced to earn lower returns under Regulation Q, small depositors began to flee thrifts and banks (McEachern 1991, p. 297).

After about fourteen years of fighting market forces, it was decided that Regulation Q would be fully repealed by March 1986. Although Regulation Q kept S&Ls on life support for over a decade, MD&A (1990) believe that it did a tremendous amount of damage by wasting an incalculable amount of resources trying to circumvent the problem of the maturity mismatch (pp. 96–97).

The Runaway 1980s

At the end of 1980, by one estimate the market value of the entire S&L industry was –$120 billion (Niskanen, 1992, p. 45). Even the popular press, which ten years later blamed the crisis on the Reagan Administration, noticed the grave condition of the industry. In "The S&Ls in Deep Trouble," *Newsweek* discussed in its December 29, 1980 issue a memo circulating among members of the transition team of the incoming Reagan administration that the new administration "'may well face a financial crisis not of its own making'" (p. 56). Although the industry was still solvent on an accounting-value basis, the "'strength of the system [was] being undermined at an alarming rate'" (p. 56). This condition of the industry, besides inspiring the DIDMCA 1980 and Garn-St. Germain 1982 "deregulations," also gave impetus to three regulatory practices: allowing variable-rate mortgages, permitting asset-maturity diversification, and actively hiding the poor financial condition of individual S&Ls behind accounting gimmicks.

The political coalition that formed and successfully pushed for the passage of the National Housing Act in the early 1930s was only partially resurrected in the 1980s to save the S&L industry. In the 1980s only construction companies, unions, and real-estate firms were involved (Mayer, 1990, p. 51). So convinced were some S&L executives that their industry was invincible, that as late as December 1988 the head of the National Council of Savings Institutions was predicting that—in spite of huge losses to FSLIC and developing news stories about the industry's financial troubles and corruption—the recent increase in deposit insurance rates levied on S&Ls would be successfully repealed. What the industry received instead was a restructuring from the George H. W. Bush Administration[4] that almost completely erased it from the financial services industry landscape (Mayer, 1990, pp. 51–52).

[4] A theory deserving future exploration is the Bush Administration's negative campaign against the S&L industry as a way to inflict damage on Bush's rivals in the Democratic power base in Texas.

By 1989, the S&L industry's long-overdue meltdown finally occurred. In a four-month period from February to May, FSLIC took control of 200 insolvent thrifts. On August 9, FIRREA was signed into law. FIRREA increased the capital requirements of S&Ls and raised the premiums that banks and S&Ls paid on deposit insurance. FSLIC was dissolved and replaced with the Savings Association Insurance Fund (SAIF) while FHLBB was dissolved and replaced by the Office of Thrift Supervision (OTS). A new agency called the Resolution Trust Corporation (RTC) was established to liquidate or sell troubled thrifts to other institutions. Last of all, FIRREA raised $115 billion over the course of three years funded by general tax revenue and by the sale of insolvent thrifts or the liquidation of their assets (Benston and Kaufman, 1990).

CONCLUSION

In conclusion, the S&L debacle was the result of about 46 years (1934–1980) of legislative and regulatory restrictions and incentives. By the end of 1980, the industry's market value was –$204.32 billion 1992 dollars[5] while the debacle was approximately $172.8 billion 1992 dollars (Barth and Litan, 1998, pp. 134, 145). Far from massive fraud inspired by *faux* deregulation being a cause, the debacle was already well in place by 1980, tremors already being felt in the mid-1960s. Austrian macroeconomic theory points the way to two other institutional causes before NHA 1934: fractional-reserve banking and federal monetary and regulatory policy. From an Austrian macroeconomic perspective (Rothbard, 1972), federal monetary and regulatory policy set the stage for the Great Depression and fractional-reserve banking contributed to the panic and runs on banks early in the Depression. Figure 1 below illustrates the approximate causal chain of events that led to the debacle.

[5] This is Niskanen's (1992) -$120 billion 1980 market-value estimate put into 1992 dollars for comparison purposes *via* the Bureau of Labor Statistics' Consumer Price Index (CPI) Inflation Calculator (bls.gov).

Figure 1. Chronological Chain of Causes and Events of the S&L Debacle (1934–1989)

Great Depression
▼
New Deal
▼
Lobbying of U.S. Congress by special interests (NAREB, AFL, etc.).
▼
NHA 1934 and creation of FHA.
▼
Creation of the long-term, fixed-rate mortgage which, in combination with present and later legislative and regulatory state and federal incentives, homogenized the composition of S&L asset portfolios to create the S&L maturity mismatch.
▼
Five yield-curve inversions in nine years (Dec. 1956-, Feb. 1957-, Aug. 1957-, Sep. 1959-, and Dec. 1965-) bring about chronic lack of profitability and difficulty covering administrative costs at S&Ls.
▼
Passage of IRCA 1966 and extension of Regulation Q (rate ceiling on deposits) to S&Ls to ease pressures caused by maturity mismatch.
▼
Three yield-curve inversions within 11 months (Dec. 1967-, Apr. 1968-, and Nov. 1968-).
▼
Innovation of the money-market mutual fund (MMMF) by Merrill Lynch in October 1972. MMMFs cause disintermediation in S&Ls as depositors seek higher market rates of return. This is the source of additional financial troubles for S&Ls, which are now subject to Regulation Q.
▼
Four yield-curve inversions in 7.5 years (Mar. 1973-, Mar. 1974-, Sep. 1978-, and Sep. 1980-) created continued trouble for S&Ls. By December 1980 the market value of the S&L industry reached -$120 billion with 330 problem S&Ls and 11 failures.
▼
DIDMCA (signed into law March 31, 1980). Sunset Regulation Q and increased asset choice for S&Ls. For 1980, the number of problem savings and loans was 330 with 11 failures.
▼
Garn-St. Germain Act (signed into law Oct. 15, 1982). Market value of industry reached –$150 billion. For 1982, the number of problem S&Ls was 744 with 76 failures.
▼
Bert Ely's Optimal Closing Point: June 1983. For 1983, the number of problem S&Ls was 689 with 54 failures.
▼
For 1984, the number of problem S&Ls was 748 with 27 failures.
▼
Tax Reform Act of 1986 reduced the value of new real estate assets held by S&Ls authorized by DIDMCA and Garn-St. Germain Act. For 1986, the number of problem S&Ls was 637 with 51 failures.
▼
For 1988, 222 S&Ls with $114 billion in assets failed.
▼
FIRREA and creation of RTC. Number of problem S&Ls reached 404. For 1989, RTC took control of 327 failed S&Ls with $147 billion in assets.

Sources: Barth (1991, 1998a); Barth and Litan (1998); Ely (1993); *Hearings*, H.R. 9620; *Hearings*, S.3603; Mayer, Duesenberry, and Aliber (1990); McEachern (1991); Niskanen (1992); *Origins* (1993); Pizzo, Fricker, and Muolo (1989); White (1991)

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