

The U.S. Banking Debacle of the 1980s: A Lesson in Government Mismanagement

by George G. Kaufman

I. Introduction

In the 1980s, the United States experienced its most serious banking crisis since the 1930s and the second most serious crisis in its 200-plus year history. The crisis affected commercial banks, savings banks, and savings and loan associations (S&Ls). Between 1980 and 1991, when fundamental corrective laws were enacted, some 1,500 commercial and savings banks (insured by the Federal Deposit Insurance Corporation) and 1,200 savings and loan associations (insured by the former Federal Savings and Loan Insurance Corporation) failed and were resolved by the regulatory agencies. These resolutions represented about 10 percent of all banks at the beginning of the period and 25 percent of all S&Ls. In addition, an even larger number of institutions were in precarious financial condition

at some time during this period. The costs of the failures were high, not only to the shareholders of the failed institutions, but also to the surviving institutions, which were required to pay premiums to the deposit insurance agencies, and to U.S. taxpayers, who were forced to make good on the losses after the resources of the S&L insurance fund had been exhausted. For banks, the loss to the FDIC and thus to other solvent banks was about \$40 billion. For S&Ls, the loss was near \$200 billion, some \$150 billion of which was beyond the resources of the FSLIC and was therefore charged to U.S. taxpayers.

The losses accrued primarily to the federal insurance agencies and taxpayers rather than to depositors and other creditors because the insurance effectively guaranteed the par value of deposits up to \$100,000 per account *de jure* and, except at some small banks, almost any amount of deposits and even borrowings *de facto*, regardless of the value of the bank's assets. The FDIC and the former FSLIC were funded by premiums imposed on banks and S&Ls, respectively, and both had implicit access to the U.S. Treasury that legislators were unwilling either to challenge or to make explicit until near the end of the debacle.

The crisis ended in the early 1990s, when

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interest rates declined, the yield curve turned steeply upward sloping, a series of rolling geographic recessions in various regions of the country came to an end, the aggregate economy slowly expanded, the real estate market bottomed out, and newly adopted legislation increased the cost of poor performance and failure to both the institutions and the regulators. By 1994, both the banking and thrift industries were in their best financial condition since the early 1960s and were realizing record profits. The number of failed and problem institutions declined sharply.

II. Background

Banking has always been a volatile industry in the United States, but until the 1930s not an unusual one.¹ The annual failure rate for commercial banks from 1870 to 1913, before the establishment of the Federal Reserve System, averaged 0.78 percent compared to 1.01 percent for nonbanks. The annual volatility of the failure rate was greater for banks, however. The relatively low failure rate existed despite a banking structure that favored failures by restricting banks to one or at best only a few offices, thus preventing them from reducing risk through geographical and product diversification. As a result, the country had thousands of independent banks; the number peaked at 30,000 in the early 1920s. The bank failures increased sharply in the 1920s to near 600 per year, but most of the failures were very small banks. Some 90 percent of the banks had loans and investments of less than \$1 million, which adjusted for inflation would be equivalent to only about \$10 million currently, and would rank them among the very smallest banks. Their failure had no visible effect on national economic activity. They were primarily located in small agricultural towns in the midwest. When a recession hit these towns from the rapid fall in farm prices after the post-World War I runup, the local automobile dealer failed, the local drugstore failed, and the local bank failed.

But things changed dramatically in the

1930s at the onset of the Great Depression. Between 1929 and 1933, the number of banks declined from 26,000 to 14,000, mostly by failure. Indeed, the very first act of newly elected President Franklin D. Roosevelt was to declare a "bank holiday" and close all banks in the country for at least one week in order to prevent depositors from cashing any more of their deposits into currency. The banks were permitted to reopen if the government found them solvent. Thereafter, banking became a relatively stable industry through the late 1970s. The number of bank failures averaged only near 10 per year and the number of S&L failures was not significantly greater. Then the picture changed again.

Before analyzing the 1980s, it should be noted that both the 1930s and 1980s debacles occurred after the creation of government institutions intended to correct failings in the system that were believed to have been at the root of the problem, and in order to reduce the likelihood of large numbers of simultaneous failures in the future. The Federal Reserve was established in 1913 in the aftermath of sharp jumps in the number of bank failures in 1894 and 1907 in order to increase flexibility in the system. The Fed was to facilitate the flow of bank reserves from capital surplus to capital deficient areas, to provide micro-liquidity through the discount window to individual solvent banks experiencing temporary liquidity problems, and to provide macro-liquidity to the banking system by offsetting outflows of currency and gold. For whatever reasons, not 20 years after it was established, the Fed failed to achieve these objectives sufficiently to prevent the banking crisis of the 1930s, which was far larger, longer, and costlier than any banking crisis before the establishment of the Fed. Indeed, the Fed appears to have introduced greater rigidities at the time of the Great Depression, e.g., prohibiting the issuance of clearing house certificates and making temporary bank suspensions more difficult, than existed before its establishment.²

In large part as a result of the Fed's failure to prevent a recurrence of large-scale bank

failures, the FDIC was established in 1934. While the Fed's decisions to provide liquidity to the banking system in order to offset depositor runs into currency were discretionary, the FDIC operated by rules that effectively eliminated the need for bank runs by unconditionally guaranteeing the par value of insured deposits regardless of the bank's financial condition. This objective was quickly realized and, combined with a more cautious set of bankers and more restrictive regulations imposed by the Banking Act of 1933, the number of bank failures dropped equally quickly and remained low for the next 50 years. However, as was true of the Federal Reserve's structure, flaws eventually appeared in the FDIC that in time led to increases in bank failures that matched the conditions in the 1930s before the introduction of deposit insurance.

III. The S&L Debacle³

Savings and loan institutions are traditional residential mortgage lenders. Before the introduction of deposit insurance in 1934, S&Ls made primarily intermediate three-to-five-year renewable mortgage loans. These loans were effectively variable rate mortgages with sizeable down payments. They were financed by time deposits (legally labeled share capital), which were not necessarily redeemable on demand. As a result, neither the S&Ls' interest rate nor liquidity exposures were very great.

But things changed dramatically after 1934. Public policy encouraged S&Ls to make progressively longer-term (first 20, then 25, and finally 30-year) fixed-rate mortgages with progressively smaller down payments. At the same time, the new deposit insurance program effectively increased the liquidity and shortened the maturity of their deposits. These changes increased the institutions' exposure to interest rate and liquidity risk. Indeed, the large degree of maturity (duration) mismatch by the mid-1970s made the industry a disaster waiting to happen.

When interest rates increased sharply in the late 1970s as a result of inflation, the

disaster occurred. Between 1976 and 1980, interest rates on three-month Treasury bills jumped from 4 percent to 16 percent and those on long-term Treasury securities from 6 percent to 13 percent. By 1982, an estimated 85 percent of all S&Ls were losing money and two-thirds were economically or market value insolvent so that, *ceteris paribus*, they would be unable to pay their depositors in full and on time. The negative economic net worth of the industry and the corresponding loss to the FSLIC was generally estimated to be about \$100 billion,⁴ although some estimates placed it as high as \$150 billion. This figure represents the difference between the par value of deposit accounts (the large majority of which were less than the maximum insured \$100,000 per account) at insolvent institutions and the market value of the S&Ls' assets. But the FSLIC resolved only a very small number of the insolvencies for a number of reasons, including:⁵

- It was overwhelmed by the large number of insolvencies, and its staff was far too small and unprepared to deal with the crisis,
- It had insufficient reserves to cover the deficits at insolvent institutions and pay off depositors at par, whether the institutions were sold, merged or liquidated,
- Formal recognition of the large losses would be a black mark on the agency's record,
- Formal recognition of the large losses and number of insolvencies might spread fear among the public and ignite a run on all institutions that would spill over to commercial banks and even beyond to the macro-economy. Further,
- Many of the losses were "only" unrecognized paper losses; and, because interest rates are cyclical and there was a high probability that they would decline again in the not very distant future, it was hoped that waiting would restore the associations to economic solvency.

Therefore, regulators publicly denied the magnitude of the problem, argued that the problem was a liquidity rather than a solvency problem, introduced creative accounting measures to make the industry's

net worth appear higher even than the already overstated book value levels (i.e., they covered up the evidence), delayed imposing sanctions on insolvent and near-insolvent institutions, and encouraged institutions to reduce their interest rate exposure by using newly permitted variable-rate mortgages and shorter-term loans to reduce their maturity mismatch. And the regulators and the industry lucked out. Interest rates declined sharply from 1982 through 1986. This reversal in rates caused the industry's net worth to rise and by 1985 its estimated negative net worth was only about \$25 billion and was expected to improve further, *ceteris paribus*.

But *ceteris* did not remain *paribus* for many institutions. A substantial number incurred increases in credit risk that offset the decline in interest rate risk and either prevented their net worth from increasing greatly or actually caused it to decline further. The assumption of credit risk was either unintentional, arising from severe local and regional economic recessions, or intentional, arising from calculated gambles to regain solvency.

The first and most severe regional recessions started in the mid-1980s in Texas and the neighboring energy-producing states in the Southwest following the collapse of world oil prices. This area had experienced a strong economic surge based on sharply rising oil prices and expectations of continued price increases. Employment, income, and real estate values all increased sharply and stimulated both a rapid immigration of people in search of employment and a building boom, particularly in commercial real estate. Much of this boom was financed by local S&Ls. When oil prices not only failed to increase further after 1981, but declined sharply from \$30 a barrel in 1985 to near \$10 in 1986, the bubble burst.⁶ As incomes and real estate values dropped, borrowers defaulted on loans, and collateral values fell too fast for many lending S&Ls to protect the value of all their loans. As a result, many S&Ls became insolvent.

At the same time, a number of institutions, particularly those that had only re-

cently converted from mutual ownership (which was the prevailing form of ownership) to stock ownership in order to raise additional capital more easily, became tempted to "gamble for resurrection." Because these institutions had little if any market value capital of their own to lose, this was a logical strategy. If the high-risk bets paid off, the institution won and possibly regained solvency. If the institution lost, the FSLIC bore the loss. That is, heads the institution won, tails the FSLIC lost! Some S&Ls placed progressively larger bets on the table by offering above market interest rates on deposits so that their deposit size grew rapidly. Such gambling was often accompanied by fraud, either *ex-ante* deliberate or *ex-ante* inadvertent through excessive carelessness in extending and monitoring loans. Particularly at the more rapidly growing associations, loan documentation was frequently incomplete or even nonexistent, record keeping casual at best, and loan collection was sporadic and done with little enthusiasm. Some of the new owners were land developers, who are gamblers almost by nature. They used greatly overinflated values of their personal properties as the base for their institution's capital, and the resources of the institution as their personal "piggy banks" to finance their ventures. Losses were often not recognized on the institutions' books on a complete or timely basis, so that the institutions gave false appearances of solvency.

The National Commission appointed in 1992 to identify and examine the origins and causes of the S&L debacle concluded that: "It is difficult to overstate the importance of accounting abuses in aggravating and obscuring the developing debacle. It would have been difficult for the process to continue for so long in the absence of an information structure that obscured the extent of the mounting losses."⁷ The FSLIC economic deficit (computed as the difference between the par value of insured deposits at economically insolvent S&Ls and the market value of their assets), which had declined from some \$100 billion in 1982 to near \$25 billion in 1985, climbed back up to

above \$100 billion in 1989, almost entirely due to losses from credit risk exposure.

Commercial banks were not as badly hit by the interest rate increase in the late 1970s because the maturities on the two sides of their balance sheets were not as mismatched. But, like the S&Ls, they experienced large credit losses in the mid and late 1980s that resulted in the largest number of bank failures since the 1930s and the second largest number in U.S. history. These losses threatened to bankrupt the FDIC.

IV. Structured Early Intervention and Resolution and Deposit Insurance Reform

The S&L and bank problems were in large part caused by deposit insurance. The structure of deposit insurance adopted in 1933 had both good and bad aspects. The good aspect effectively prevented a systemwide run from deposits into currency by guaranteeing the par value of most deposits. Thus, it prevented the type of reserve drain experienced in the United States in the early 1930s.

The bad aspects were, first, that this guarantee reduced, if it did not eliminate, the incentive for many depositors to monitor the financial performances of their banks and thus encouraged both a moral hazard problem for banks and a principal-agent problem for regulators. Bank managers/owners, knowing that few if any depositors were looking over their shoulders and that their insurance premiums were not scaled to their risk exposure, deliberately or inadvertently assumed greater risks either by increasing the credit and interest rate risk exposures in their portfolios and/or by decreasing their capital-asset ratios more than they would have in the absence of insurance. Bank regulators, knowing that most depositors had little if any incentive to flee financially troubled banks, were then able to delay imposing sanctions on troubled institutions and even resolving insolvent institutions, thereby keeping them in operation. To the extent that these insti-

tutions increased their losses, the regulators' principals—healthy, premium-paying institutions and taxpayers—were not well served.⁸

In an attempt to solve the problem, Congress at year-end 1991 enacted the FDIC Improvement Act (FDICIA), which focusses on structured early intervention and resolution (SEIR). SEIR reforms deposit insurance by attempting to impose on insured depository institutions the same conditions that the private market imposes on firms not covered by federal insurance whose financial condition is deteriorating, including conditions that the banks themselves impose on their borrowers. Moreover, it attempts to resolve troubled institutions before their own capital turns negative. Thus, losses would accrue only to shareholders, not to depositors, and deposit insurance would effectively be redundant.

SEIR's objective is also to reduce the discretion of regulators by imposing more specific rules, thus reducing the power of regulators. As such, it resembles the partial replacement of Federal Reserve discretion by FDIC insurance rules following the Fed's failure to prevent the banking crisis and economic depression of the early 1930s.⁹ To protect their power, the regulators successfully fought to weaken many of the provisions reducing their discretionary authority during the legislative processing leading to the enactment of FDICIA and continued to weaken the potential effectiveness of the Act further by drafting weak regulations to implement it.¹⁰

V. The Lesson

An analysis of the experience of the U.S. banking debacle of the 1980s suggests that to minimize the moral hazard problem federally insured depository institutions should be subjected to the same conditions imposed by the private market on noninsured firms and that to minimize the regulators' principal-agent problem the insurer and other bank regulatory agencies should be required to operate in a transparent manner, be prohibited from providing forbearance, and

be held fully accountable for their actions and inactions.

The major source of both the instability in the U.S. banking system in the 1980s that resulted in the exceptionally large number of bank and S&L failures and the associated large losses was not the private sector but the public or government sector. The government first created many of the underlying causes of the problem by forcing S&Ls to assume excessive interest rate risk exposure and preventing both S&Ls and banks from minimizing their credit risk exposure through optimal product and geographic diversification and then delayed in applying solutions to the problem by granting forbearance to economically insolvent or near-insolvent institutions. That is, the banking debacle was primarily an example of government failure rather than market failure. □

1. A brief history and additional references appear in George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane and George G. Kaufman, *Perspectives of Safe and Sound Banking*, Cambridge, Mass.: MIT Press, 1986, Chapter 2.

2. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States 1867-1960*, Princeton, N.J.: Princeton University Press, 1963, Chapter 7.

3. Although savings banks have more in common with S&Ls than commercial banks, because they were insured by the FDIC rather than the FSLIC, data on them is included with that for commercial banks.

4. See Bert Ely, "Savings and Loan Crisis" in David R.

Henderson, ed., *Fortune Encyclopedia of Economics*, New York: Warner Books, 1993, p. 72.

5. Edward J. Kane, *The Gathering Crises in Federal Deposit Insurance*, Cambridge, Mass.: MIT Press, 1985; *The S&L Insurance Mess: How Did It Happen?* Washington, D.C.: Urban Institute Press, 1989, James R. Barth, *The Great Savings and Loan Debacle*, Washington, D.C.: American Enterprise Institute, 1991; George G. Kaufman, "The Savings and Loan Rescue of 1989: Causes and Perspective" in George G. Kaufman, ed., *Restructuring the American Financial System*, Boston: Kluwer Academic, 1990; George J. Benston and George G. Kaufman, "Understanding the Savings and Loan Debacle," *The Public Interest*, Spring, 1990, pp. 79-95; National Commission on Financial Institution Reform, *Recovery and Enforcement, Origins and Causes of the S&L Debacle: A Blueprint for Reform—Report to the President and Congress of the United States*, Washington, D.C., July 1993; Martin Lowy, *High Rollers: Inside the Savings and Loan Debacle*, New York, Praeger, 1991; and Martin Mayer, *The Greatest Ever Bank Robbery: The Collapse of the Savings and Loan Industry*, New York: Charles Scribner, 1990.

6. Paul M. Horvitz, "The Collapse of the Texas Thrift Industry" in George G. Kaufman, ed., *Restructuring the American Financial System*, Kluwer, 1990, pp. 95-116.

7. National Commission, p. 9.

8. Edward J. Kane, "Changing Incentives Facing Financial-Services Regulators," *Journal of Financial Services Research*, September 1989, pp. 265-274 and Edward J. Kane, "How Market Forces Influence the Structure of Financial Regulation" in William S. Haraf and Rose Marie Kushmeider, eds., *Restructuring Banking and Financial Services in America*, Washington, D.C.: American Enterprise Institute, 1988, pp. 343-382.

9. The battle between rules and discretion in banking regulation resembles the more publicized and longer-run battle between rules and discretion in the conduct of monetary policy carried on in the U. S. at least since the 1930s.

10. George J. Benston and George G. Kaufman, "Improving the FDIC Improvement Act: What Was Done and What Still Needs to be Done to Fix the Deposit Insurance Problem" in George G. Kaufman, ed., *Reforming Financial Institutions and Markets in the United States*, Boston: Kluwer Academic, 1994, pp. 99-120; and Kenneth E. Scott and Barry R. Weingast, "Banking Reform: Economic Propellants, Political Impediments" in George G. Kaufman, ed., *Reforming Financial Institutions and Markets in the United States*, 1994, pp. 19-36.

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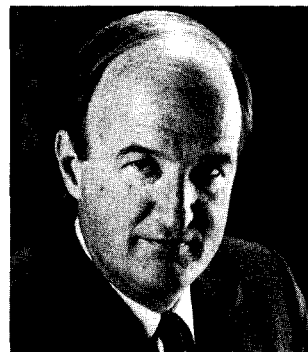
Bankers and Regulators

The current U.S. financial structure, in despair and disrepute, is the logical outcome of financial thought that places legislators and regulators in the center of things. It is a precarious system that builds on government insurance and government guarantees and, in final analysis, depends on monopoly money and legal tender force. It is a discredited system that is inflicting immeasurable harm on many people.

The seventeen essays in this volume, all selected from earlier issues of *The Freeman*, examine in detail the failure of regulation and offer hope for a return to sound banking. The collection includes, among others, articles by Hans F. Sennholz, Ken S. Ewert, E.C. Pasour, Jr., Kurt Schuler, Richard M. Salsman, and Lawrence H. White.

176 pages, indexed, \$14.95 paperback

Friedman vs. The Austrians, Part II: Was There an Inflationary Boom in the 1920s?



“I have no reason to suppose there was any over-investment boom . . . during the 1920s.”
—Milton Friedman

In my continuing exchange of letters with Professor Milton Friedman, the free-market economist challenged followers of the Austrian school to provide evidence of an overinvestment boom in the 1920s. He reiterated what he and Anna Schwartz concluded in *A Monetary History of the United States*: the 1920s was the “high tide” of Federal Reserve policy, inflation was virtually non-existent, and economic growth was reasonably rapid. Monetarists even deny that the stock market was overvalued in 1929! In short, “everything going on in the 1920s was fine.”¹ The problem, according to Friedman, was not the 1920s, but the 1930s, when the Federal Reserve permitted the “Great Contraction” of the money supply and drove the economy into the worst depression in U.S. history.

In contrast to Friedman and the Monetarists, the Austrians argue that the Federal Reserve artificially cheapened credit during most of the 1920s and orchestrated an unsustainable inflationary boom. The stock market crash of 1929 and subsequent economic cataclysm were therefore inevitable.

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An interesting historical sidelight is the fact that Irving Fisher, the principal Monetarist of the 1920s, completely failed to anticipate the crash, while Austrian economists Ludwig von Mises and Friedrich Hayek predicted the economic crisis, although they did not pinpoint an exact date. Ever since then, Monetarists have argued that the 1929–33 debacle was unforecastable and have made every effort to show that there were few if any signs of trouble during the 1920s. The Austrians, in contrast, have attempted to confirm Mises-Hayek’s view that the government created an inflationary boom that could not last, especially under an international gold standard.²

Was there an overinvestment boom in the 1920s? The answer depends on which statistics you examine. The “macro” data favors the Monetarists’ thesis, while the “micro” data supports the Austrians’ view.

In support of the Monetarists, the broad-based price indices show little if any inflation. Average wholesale and consumer prices hardly budged between 1921 and 1929. Most commodity prices actually fell. Friedman and Schwartz conclude, “Far from being an inflationary decade, the twenties were the reverse.”³

However, other data support the Austrian view that the decade was aptly named the Roaring Twenties. The 1920s may not have been characterized by a “price” inflation, but there was, in the words of John Maynard Keynes, a “profit” inflation. After the 1920–21 depression, national output (GNP)