

Chapter 33

The U.S. Savings and Loan Crisis

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1. Introduction

Between 1980 and March 31, 1992, federal agencies disposed of over 1100 insolvent Savings and Loan (S&L) institutions and, as of March 31, 1992, an additional 408 S&Ls holding 29% of the industry's assets were classified as troubled.¹ Because the Federal Savings and Loan Insurance Corporation reserves have been exhausted, the vast majority of the past and future costs of these failures will be absorbed by U.S. taxpayers. As of May 1993, resolving these failures has cost taxpayers nearly \$200 billion and the Resolution Trust Corporation (RTC) had an additional \$69 billion of assets (net of cash and near cash assets) in receivership or operating as RTC conservatorships.² Most of the insolvencies occurred after 1988 and their cause is frequently attributed to the deregulation of the industry in 1980 and 1982. In fact, this crisis developed over a substantially longer period and had other significant contributory causes. The abysmal performance of Savings and Loan Associations (S&Ls) over the past decade is, in part, the consequence of a fundamental flaw in the structure of these institutions and is also attributable to regulatory and supervisory mistakes predating the events of the late 1980s and early 1990s.

2. A predisposition to failure

2.1. *The key roles of U.S. Savings and Loan Associations*

Until 1980, S&LS performed a narrowly defined role in the U.S. financial system. The bulk of their asset operations involved originating, investing in, and

¹ See Barth & Brumbaugh [1992] for data on failures and failure resolution costs. The data on the number of institutions classified as troubled was taken from Office of Thrift Supervision [1992] and includes 354 institutions 'considered by OTS to be troubled but not projected to require federal assistance' and 54 institutions that are projected to require federal assistance.

² See the *RTC Review*, Vol. IV, No. 7 (July 1993). As of May 1993, Resolution Trust Corporation outlays due to S&L closures totalled \$191.1 billion. In addition, the RTC had incurred \$7.5 billion in interest cost on borrowings from the Federal Financing Bank. The final cost of the S&L resolution appears likely to exceed \$225 billion.

servicing home mortgages. On the liability side, they accumulated household savings plus some form of net worth to finance the mortgage portfolio.

As mortgage originators, S&Ls served the basic lending function of precontract monitoring of the mortgage borrower. They expended resources to evaluate individual investments in real estate properties and to determine the conditions under which a mortgage loan would be made. Leland & Pyle [1977], Diamond [1984], and others have observed that providing this monitoring service through a financial intermediary can only be sustained if the gains from collective monitoring exceed the costs of convincing the primary investors (mainly the depositors) that the screening process has correctly identified loan values. Models in which collective monitoring justifies the existence of depository and nondepository intermediaries are discussed in Bhattacharya & Thakor [1991].

Collective monitoring need not involve continuing investment by the monitoring firm in the loans it originates. In mortgage markets, brokers provide the precontract monitoring and pass the mortgage loans they originate on to other lenders. Until recently, S&Ls did not engage heavily in mortgage brokerage operations. Instead, they held most of the mortgage loans they originated in their own portfolios. This required them to engage in an asset transformation process. The nature of this transformation changed over time ultimately resulting in an asset/liability structure subject to significant interest rate risk. The maturity mismatch between long-term, fixed rate mortgage assets and short-term deposit liabilities was a major cause of the series of S&L crises that began in the mid-60s.

Diamond & Dybvig [1983] provide a theoretical analysis of maturity transformation by financial intermediaries. See Bhattacharya & Thakor [1991] for additional references and a review of this topic. In its most basic form, maturity transformation involves a mismatch between the contract length of an intermediary's assets and that of its liabilities. Typically, this mismatch involves holding illiquid assets with contract lengths greater than those of the intermediary's liabilities. The resulting risks to an intermediary's net worth come from two sources, default by the borrowers and untimely withdrawal or nonrenewal of the liabilities. The first of these risks is common to all intermediary structures; the second can occur only where there is an asset/liability liquidity mismatch. Until the advent of broad secondary markets for mortgage-backed securities, mortgage loans were illiquid.³ In contrast, S&L liabilities became more liquid over time, i.e. available on demand or short notice without penalty.

Maturity transformation may also involve interest rate risk. Absent regulatory constraints, it is unnecessary for S&Ls to couple liquidity transformation with interest rate risk as their more recent reliance on adjustable rate mortgages demonstrates.⁴ Until the late 1970s, when they were able to loan at variable

³ There is an important link between the monitoring and liquidity creation functions of an intermediary. Even though an underlying asset is long-lived, as is the case for single-family homes, the loan that finances the asset will only be illiquid to the extent that reliable information on the loan's value cannot be efficiently transferred from one holder to another.

⁴ See Bhattacharya & Thakor [1991] for a discussion of conditions under which the coupling of liquidity creation and interest rate risk would be necessary.