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THE SAVINGS AND LOAN DEBACLE: THE CULMINATION OF THREE DECADES OF CONFLICTING REGULATION, DEREGULATION, AND RE-REGULATION

Abstract: The role of the public accounting profession in the savings and loan debacle of the 1980s has recently been the subject of Congressional inquiry and extensive litigation by government agencies, and by angry stockholders and bondholders. These efforts suggest a broad misunderstanding by the public of the causes of the disaster. this paper illustrates that the difficulties which precipitated the crisis were a result of the historical development of the regulatory environment of the savings and loan industry. Examining this regulatory environment helps in understanding the current problems and crises of savings and loans as well as the situation in which the accounting profession now finds itself.

The paper illustrates that the manner in which the industry was regulated, including piecemeal and often conflicting legislation, locked the industry into long-term mortgage commitments and then urged diversification from these commitments. The paper illustrates that, over the years, industry responses to this legislation created a net worth crisis. The extent of the crisis was obscured by accounting principles developed by regulators, and which ran contrary to GAAP. Finally, the paper discusses recent legislation designed to correct the regulatory and accounting inconsistencies, and the anticipated effect of this legislation on the future of the savings and loan industry.

The end of the 1980s decade was marred by the financial collapse of many savings and loan institutions. Current estimates of federal expenditures necessary to bail out the savings and loan industry from its financial debacle generally exceed $100 billion and some estimates range as high as $300 billion [Adams, 1990, p. 17; Pilzer, 1989, p. 233]. When interest costs on 30 to 40 year debt used to finance the federal bailout are included, cost estimates rise steeply to between $500 billion and $1 trillion [Carlton, 1992]. The *"true"* cost of the bailout will *not* be known for years to come, until all of the failing institutions have been shut down, merged, and sold off; until the Resolution

Trust Corporation liquidates its holdings; and until all of the tax breaks and special portfolio performance guarantees granted to acquiring institutions have expired. Meanwhile, the American public is still asking: how the fiasco came about; who should be blamed for it; and how the clean up should be financed.

These are questions of particular concern for accountants for the following reason. While the responsibility for the widespread failure in the industry has not yet been fully determined, the role of the public accounting profession as well as the accounting standards, principles, procedures, and rules for savings and loan financial reporting have been called into question. Auditors of failed savings and loans have been shouldering part of the blame for the fiasco and some of the financial responsibility for the clean up, as a result of various lawsuits by federal agencies.[1] In addition, auditors have been subjected to various class action lawsuits brought by investors in failed savings and loans.[2] These lawsuits, whether justified or not, reflect a myopic perspective of how the debacle occurred. The thrift debacle was not simply the result of audit irregularities, Federal Home Loan Bank Board forbearance in closing troubled institutions, or fraud and mismanagement by thrift industry executives. Although each of these factors contributed substantially to the crisis, the problem was also fundamentally rooted in the historical regulation of the industry.

This paper discusses, from a historical perspective, the regulatory environment of the savings and loan industry. Examining this regulatory history helps in understanding the current

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[1]By April 1986, 38 investigations had been launched by the Federal Deposit Insurance Corporation (FDIC) and $3,319,000 had been turned over to the FDIC by various auditors [U.S. General Accounting Office, 1986]. The Resolution Trust Corporation (the agency designated to dispose of the assets of failed savings and loans) has recently filed suits against the following CPA firms for their roles in failed savings institutions: KPMG Peat Marwick, $154 million; Deloitte and Touche, $444 million; Pannell Kerr Forster, $41 million [Pickering, 1992]. Ernst and Young agreed to a total comprehensive settlement of $400 million. This agreement was reached with the federal thrift regulations to resolve all "current and potential claims" against the firm for its role in audits of failed depository institutions [Eldridge, 1992].

[2]Recently Ernst and Young agreed to pay a total of $63 million to settle a class action lawsuit related to failed Lincoln Savings and Loan [Stevens, 1992, p. A3]. In addition to this settlement, Ernst and Young agreed to pay the Resolution Trust Corporation $41 million [*Public Accounting Report*, 1992]. Arthur Andersen has also paid a total of $30 million to bondholders of Lincoln Savings and Loan [*Public Accounting Report*, 1992].

problems and crises of savings and loans as well as the situation in which the accounting profession now finds itself. The paper illustrates how changes in regulations and conflicting regulatory intentions laid the framework for the savings and loan debacle. Finally, this paper calls for greater coordination of Congressional goals for savings and loans, and the financial services industry, as the only way to achieve a lasting resolution to thrift industry problems. The remainder of this paper is organized as follows: The Early Years; Post Depression Years Through the 1960s; The 1970s: Disintermediation and Consumerism; The 1980s: Deregulation, Expansion, Crisis, Re-regulation; and What will the 1990s Bring?

THE EARLY YEARS

The first savings and loan institution was organized in 1831. Its primary purpose was to finance home ownership for association members. At this time, commercial banks were not filling this need because they perceived their role as financing the capitalization of industry [Ewalt, 1962, p. 372]. With the growing industrialization of the nation and the need for housing for urban residents, savings and loans spread across the country to serve savers and home mortgage borrowers. The spread of the thrift industry spurred a tremendous growth in residential construction across the nation. This construction boom became a leading factor in the prosperity of the 1920s [Keith, 1973].

Throughout this developmental period from 1831 into the 1920s, the institutions were chartered by states and were regulated by laws which varied greatly between states. Many states had no requirement for the establishment of reserves against losses on loans; consequently, some institutions paid out essentially all profits in dividends to shareholders. In addition, mortgage repayment arrangements frequently failed to provide for methodical reduction of the principal balance of loans. Mortgage financing arrangements too frequently involved first, second, and third mortgages financed over periods of 10 to 15 years. This was not a great problem while real estate prices were stabilized or rising with the economic boom in the stock market. However, in 1929, the stock market crashed and real estate prices plummeted.

Early in the 1930s, institutions found themselves with delinquent loans, foreclosures, and a bulk of repossessed real estate assets. With so much repossessed property for sale, even at re-

duced prices, little property was changing hands because of a lack of public confidence in the real estate market and the banking industry. Furthermore, with assets that were illiquid and having paid out most of the profits in prior years as dividends, the savings and loans were in deep financial difficulty. As part of legislation to restore financial vitality and public confidence in the banking system, Congress enacted several laws aimed at promoting stability in the housing market and the savings and loan industry. Among these laws were the Federal Home Loan Bank Act (1932), the Home Owner's Loan Act (1933), and the National Housing Act (1934). Some of the major provisions of these laws were as follows.

First, the Federal Home Loan Bank Act established the Federal Home Loan Bank (FHLB) System operated by the Federal Home Loan Bank Board (FHLBB). The intent of the Act was to help hard pressed homeowners who could not get mortgage funding from banks to receive financing from a FHLB member. Thus, the purpose of the Board and the system was primarily to advance funds to Federal savings and loans so that they could advance the funds to homeowners. Secondarily, the Board regulated those institutions participating in the funds advancement. This latter purpose was largely implemented in two ways. First, the Board took an active role in evaluating proposed laws to determine their effect on the financial well-being of the industry, and then lobbied Congress on the thrifts' behalf. Second, the Board assured "that regulated institutions adhered to written laws and regulations" [Strunk and Case, 1988, p. 109]. This function was a very legalistic one, which did not necessarily coincide with determining the financial soundness of individual institutions. While these provisions of the Federal Home Loan Bank Act served to stabilize the mortgage market by making funds available on a regular basis, emergency funding was made available by the Home Owners Loan Act.

The Home Owners' Loan Act of 1933 provided emergency mortgage funding to distressed home-owners by offering them long-term mortgage loans (15 year periods), with fixed interest rates capped at 5% initially. This Act further provided that Federal savings and loans could only lend their funds for home mortgages and combinations of home and business property mortgages; and these loans could only be made within 50 miles of the association's home office. Finally, the Act specifically exempted Federal savings and loans from federal taxation and

from taxation by any state. This offered the institutions tax protection for the purpose of rebuilding their reserves.

The third major act, The National Housing Act, established the Federal Savings and Loan Insurance Corporation (FSLIC) to insure depositors at the savings associations. It also established the Federal Housing Administration (FHA) to insure savings associations against losses on mortgages and home improvement loans and to regulate amortization of those loans. Additionally, the Act established the Federal National Mortgage Association (FNMA or Fannie Mae) to create a secondary market for mortgages.[3] Finally, the Act provided that each institution establish a reserve of 5% of deposits. Institutions were given 10 years to meet this goal. These three laws marked the first Federal involvement in the housing industry, and reflect the national recognition of the important role of savings and loans in home ownership. This depression-era legislation set the framework for the system of federally chartered savings and loans.

THE POST-DEPRESSION YEARS THROUGH THE 1960s

Under this regulatory framework, the savings and loan industry returned to prosperity in the late 1930s. From then until the late 1960s, the institutions experienced increasing profit margins. This prosperity was the result of several factors including the following. First, World War II promoted high long-term mortgage rates and low short-term interest payments to depositors, with rates remaining relatively stable throughout the 1940s, 1950s and early 1960s. Second, a tremendous post-war prosperity was experienced across the nation. Third, the middle class enlarged, and society began moving to the suburbs. Fourth, real estate prices escalated; and, fifth, the Federal government established a continuing concern for housing development [Ewalt, 1962, pp. 255-341]. This Federal concern for housing fueled savings and loan prosperity during the Post-Depression years; however, it also established the framework for the difficulties the industry would encounter in the 1970s, and ultimately the 1980s, for the reasons detailed below.

[3]Provisions of these Acts are summarized in U.S. Congress, *Evolution of [the] Role of the Federal Government in Housing and Community Development*, 1975.

Increasing Role of Federal Government in Setting Mortgage Terms

During the post-depression years, the availability of the secondary mortgage market (through Fannie Mae) enabled institutions with excess cash to participate in the prosperous mortgage lending in booming housing markets. However, in order for institutions to sell mortgages through Fannie Mae, the mortgages had to meet FHA criteria. These criteria related most notably to the length of the loan repayment period, the percentage of appraised value eligible for loan financing (referred to as *loan-to-value* ratios), and interest rate caps on the loans. Initial repayment periods were 15 to 20 years, with loan-to-value ratios of 80%. These values were changed almost annually through the 1940s and 1950s in various Housing Acts. One of these Acts, the Servicemen's Readjustment Act of 1944 (the G.I. Bill of Rights), established a program of government regulated, government insured loans especially for veterans. Provisions of these loans were similar to FHA loan provisions. The loans were administered by the Veterans Administration (VA) and eventually became known as *VA loans.*

The VA and FHA loan terms at times had repayment periods extended to 40 years, and at times loan to value ratios were as high as 97% [Mason, 1982, p. 64]. The government rationale for supporting such generous mortgage terms continued to be that "housing is a segment of the economy demanding special treatment to assure a flow of credit which it would not ordinarily attract" [Ewalt, 1962, p. 262]. This government philosophy was effective in attracting capital to the mortgage market, primarily in the form of a growth in mortgage bankers. The mortgage bankers aggressively marketed FHA and VA insured loans with long maturities and low interest rates. They then sold these loans to Fannie Mae. This fierce competition from the mortgage bankers forced the savings and loans to make FHA and VA qualified loans, or, alternatively, to make conventional loans which closely paralleled the long repayment periods, low interest rates and generous loan to value ratios of the FHA loans. Thus, the FHA loan terms became the industry standard, and savings and loans began to lock themselves into 20, 30, and 40 year loan commitments.

Fuelled by generous FHA and VA loan terms, and FSLIC insurance guarantees, housing starts in the 1950s and 1960s reached record levels; and the savings and loan industry continued to prosper. This prosperity led to the creation of new sav-

ings and loan institutions, and these associations were given up to 20 years to meet the 5% reserve requirement established in the National Housing Act. During this period of increasing prosperity for savings and loans, the institutions found their assets expanding in geometric proportions. At the same time, commercial banks were experiencing only modest growth [Woerheide, 1984, p. 5]. The commercial banking industry attributed the savings and loan prosperity to favorable tax treatment because, during the World War II and Post-War Era, savings and loan associations were not subject to federal income taxation. The tax policy at that time (consistent with the regulatory policy) was that these institutions served a vital role in financing the development of residential housing, an important national goal [Biederman and Tuccillo, 1976, p. 5]. In addition, since savings and loans were traditionally mutually owned, they were viewed as tax conduits for the depositors/owners. This preferential tax treatment, not available to commercial banks, was a continual irritant to the commercial banking industry which voiced complaints about this unfair tax treatment afforded savings and loans.

The Revenue Act of 1951

Commercial banking arguments centered around the fact that savings and loans were in direct competition with commercial banks for savings deposits; and that if savings and loans were to be allowed to compete with banks for deposits, they should be subject to equal taxation [U.S. Congress, 1951, p. 783]. In response to these and other persuasive arguments advanced by commercial banks, the Revenue Act of 1951 amended the *Internal Revenue Code of 1939* to treat savings and loans as regular corporations.[4] This Act set the framework for savings and loan taxation. It was significant because it signalled a shift in tax policy which lost some of its focus on protecting saving and loans because of their commitment to housing finance, and

[4]Several exceptions to this general rule of taxing savings and loans as regular corporations have developed over the years. Major exceptions include: the percentage of taxable income bad debt deduction (discussed at length in the text of this paper), ordinary loss treatment from the sale of corporate and government securities, deduction for interest incurred to carry tax-exempt bonds (pre-Tax Reform Act of 1986) and a longer net operating loss carryback period (pre-Tax Reform Act of 1986). These exceptions, as well as several less significant ones, are explained more fully by Halperin [1971] and by Clark [1975].

moved towards the concept of tax equality among thrifts and banks competing for consumer deposits. This shift marked a divergence in tax policy and FHLBB regulatory policy. Although the tax policy shift at this time was major, the actual tax impact was negligible for the following reason.

The Revenue Act of 1951, in addition to subjecting savings and loans to taxation for the first time, provided them a choice of methods for determining their allowance for bad debts. This allowance then determined the bad debt deduction for tax purposes. Like other corporations, savings and loans could choose to set up their allowance based on actual bad debt experience, averaged over a specified period of years. In lieu of this experience method, they could choose the percentage of taxable income bad debt deduction.[5] This method enabled the institutions to write off as much as 100% of their taxable income to a reserve for bad debts. The balance of this reserve, together with earned surplus and undivided profits, was limited to 12% of total deposits. This limitation was, as a practical matter, seldom a binding constraint [U.S. Congress, 1969, p. 3514]. Thus, while savings and loans were nominally taxable entities, few paid any income tax until the passage of the Revenue Act of 1962.

The Revenue Act of 1962

In 1962, Congress again devoted its attention to the issue of savings and loan taxation. This reconsideration was initiated by President Kennedy's demand for a review of the taxes of "private savings and lending institutions [that] are accorded tax deductible reserve provisions which substantially reduce or eliminate their Federal income tax liability" [U.S. Congress, 1961, p. 2]. As a result of the ensuing Congressional review, the Revenue Act of 1962 reduced the percentage of taxable income bad debt deduction rate to 60% of taxable income. Subsequent to this change, effective tax rates of savings and loans rose (see Exhibit

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[5]Savings and loans could also choose a method known as the "3-percent method" which allowed them to set up a reserve at three percent of eligible loans (as defined in the *Internal Revenue Code of 1939*). This method became known in the *Internal Revenue Code of 1954* (IRC) as *the percentage of eligible loans method.* This method underwent few changes from 1954 to 1986 when it was struck from the law in the Tax Reform Act of 1986. For this reason, and since most of the controversy over bad debt deductions for savings and loans focused on the percentage of taxable income bad debt deduction, this method is not discussed further in this paper.

1). The Act also added a restriction that savings and loans using this deduction were required to hold at least 72% of their assets in "qualified assets." *Qualified assets* included residential real property loans; loans secured by members' deposits or by church facilities; cash and U.S. government obligations; and property used in conduct of the institution's business [*Internal Revenue Code* (IRC) section 7701(a)(19)(C)]. This was the first explicit linking in the tax law between the percentage of taxable income bad debt deduction and an institution's investment in mortgages. It also placed the tax law in the position of dictating specific investments allowable for savings and loans. This introduced a conflict in allowable investments for tax and regulatory purposes.

At this time, savings and loans had little choice but to accept their tax increase because the regulatory rules which specified permitted savings and loan investments were even more stringent than the 72% investment in qualified assets required for tax purposes.[6] While the tax law did not specify how the remaining 28% of assets had to be invested, regulatory rules limited investments exclusively to: (1) residential mortgage loans on one to four-family home types, (2) loans secured by members' deposits, (3) cash, (4) government securities, (5) property used in conduct of the institution's business, (6) residential property improvement loans (limited to 15% of total assets), or (7) loans on the security of improved real estate other than one to four-family home types (limited to 20% of total assets) [12 CFR 545.11]. Thus, for all practical purposes, regulatory investments, other than cash, government bonds, business property, and loans secured by members' deposits, were committed to residential mortgages and improvements to residential property. Effectively only 20% of an institution's assets could be invested in anything other than residential property and related loans. Because of these constraints, savings and loans had to maintain approximately 80% of their assets invested in qualified assets to meet regulatory requirements.

[6]Savings and loans could have expanded their investment in tax free government bonds in order to avoid incurring a greater tax burden. Baer [1983] illustrates the potential benefits of this strategy. Hendershott and Koch [1980], however, present contradictory evidence showing that relative before tax returns on taxable and non-taxable investments would have to be in excess of their historic relationship to make this strategy worthwhile.

EXHIBIT 1

Aggregate Effective Tax Rates of Savings and Loan Associations, 1960-1988

(Dollars in Millions)[a]

Year	Net Income Before Taxes	Taxes	Effective Tax Rate
1960	$ 552	$ 4	0.7%
1961	716	3	0.4
1962	820	3	0.4
1963	764	93	12.2
1964	919	131	14.3
1965	929	134	14.4
1966	727	97	13.3
1967	711	95	13.2
1968	1,011	148	14.7
1969	1,230	194	15.8
1970	1,166	241	20.7
1971	1,748	434	24.8
1972	2,317	630	27.2
1973	2,655	758	28.5
1974	2,144	661	30.8
1975	2,082	634	30.5
1976	3,219	969	30.1
1977	4,610	1,412	30.6
1978	5,717	1,799	31.5
1979	5,198	1,578	30.4
1980	1,193	409	34.3
1981	-6,148	-1,516	N/A
1982	-5,869	-1,598	N/A
1983	2,561	593	23.2
1984	1,871	770	41.2
1985	5,951	2,112	35.5
1986	3,300	3,100	N/A[b]
1987	-4,100	2,700	N/A[b]
1988	-11,565	1,874	N/A[b]

[a] Information obtained from U.S. League of Savings Institutions [1989, p. 50] and U.S. Congress [1983, p. 286].

[b] Industry-wide effective tax rates for these years are meaningless because they reflect a growing disparity in income between profitable and unprofitable institutions.

Such an investment level was not a hardship for the institutions during this time period because, as discussed previously, profit margins were relatively stable, demand was relatively stable, and real estate prices were rising. This was the last time

the industry experienced such stability. In the years following 1961, further conflicts developed between allowable assets for tax and regulatory purposes, thereby sending the industry a mixed message on the role it was expected to play in home financing. Tax burdens on the industry increased; and Regulation Q was imposed by regulators. The regulatory rationale for the implementation of Regulation Q is explained in the following section.

Regulation Q Imposed

Beginning in the mid-1960s, inflation became a serious problem. Fuelled by the Vietnam War, which the government tried to finance without a major tax increase, inflation rates became higher and more variable than in the past [Carron, 1982, p. 5]. The rampant inflation exerted upward pressure on market interest rates, which were also being driven upwards by competition among savings and loans in the western and eastern portions of the country, and between banks and savings and loans.

By 1966, interest rates reached a 100 year high [Bowden and Holbert, 1984, p. 28]. The Federal government became concerned about savings and loans' ability to pay these high interest rates to depositors. Since their portfolios were tied up in long-term, fixed-rate residential mortgages, savings and loans were unable to make rapid adjustments in their revenue base to offset the rising cost of short-term borrowing (deposits). Thus, the industry was trapped by fixed-yield, long-term investments financed by short-term borrowing at volatile interest rates. To protect the savings and loan industry, in 1966 the Federal government imposed Regulation Q deposit rate ceilings on savings and loans. This was viewed as a viable means of keeping down savings and loans' cost of funds and protecting the industry from competitive forces. Subsequent to imposition of Regulation Q, market rates dropped and some observers believed that savings and loans were out of trouble. This belief may have been at least partially responsible for the imposition of additional taxes on savings and loans in the Revenue Act of 1969.

The Revenue Act of 1969

The Revenue Act of 1969 increased savings and loan taxes by reducing the percentage of taxable income limit for the bad

debt deduction. During the hearings which preceded this act, the savings and loan industry requested that the definition of qualified assets be expanded to encompass new regulatory powers.[7] Regulators had expanded savings and loan allowable assets to include certain education loans (up to five percent of total assets), housing for the aging (up to five percent of total assets), loans on improved real estate other than residential property, and loans for the acquisition and development of land (raised from 15% to 20% of total assets) [12 CFR 545.6-545.8]. However, the industry was unable to pursue these investments because of the stringent asset restrictions of Section 7701(a)(19) of the *Internal Revenue Code*. Thus, the tax law and operating regulations were in conflict.

As a partial response to industry pleas, the 1969 Act expanded qualified assets to include: loans secured by commercial property in certain urban renewal areas; loans secured by school, health, or welfare facilities; and student loans. However, the qualified assets percentage was increased to 82%, and a sliding scale implemented for investment levels from 82% to 60%. For every one percent of an institution's portfolio which fell below 82%, the bad debt deduction was reduced by three-fourths of one percent. Once the institution's portfolio fell to less than 60% investment in qualified assets, it could no longer use the percentage of taxable income bad debt deduction.

This marked the widest divergence yet in tax and regulatory policy. While regulators were becoming more lenient in allowing institutions some limited diversification out of residential mortgages (up to 30% of the portfolio), the tax law was imposing a tax penalty for diversification in excess of 18%. In addition to this constraint, the Act reduced the deduction rate from 60% to 40%, phased in over a 10 year period. Thus, even those institutions not diversifying experienced a tax increase.[8] This tax increase contributed to a severe financial crunch which gripped the industry in the 1970s.

[7]See testimony of William J. Hallahan, Consultant on Monetary Policy and Economic Affairs, National League of Insured Savings Associations [U.S. Congress, 1969, p. 3524].

[8]See Exhibit 1 for a summary of Savings and Loans effective tax rates following the 1969 Act.

THE 1970s: DISINTERMEDIATION, CONSUMERISM AND NET WORTH CRISIS

During the 1970s, a growing rate of inflation was experienced across the country. This was attributed in part to the Federal government trying to finance the Vietnam War without any major tax increase, and to the Organization of Petroleum Exporting Countries (OPEC) 100% increase in oil prices. In an effort to curb the growing inflation problem, the Federal Reserve Bank increased its discount rate and its reserve requirements to record levels. It also implemented a new monetary control policy which focused on regulation of the total reserves of the banking system instead of regulation of short-term interest rates. Subsequent to announcement of this policy, short-term market interest rates rose rapidly. This precipitated financial chaos in the savings and loan industry.

During the 1970s and early 1980s, savings and loans were prevented by Regulation Q from passing these high short-term market interest rates on to their depositors. This situation motivated depositors to withdraw funds from savings and loans in order to invest in alternative, higher yielding investment vehicles (particularly money market mutual funds) offered by unregulated intermediaries. This disintermediation forced savings and loans to enter the market as short-term borrowers, paying very high interest rates on borrowed funds. Meanwhile, their income-generating portfolios were tied up in long-term, low interest bearing, fixed-rate mortgages. This latter problem was largely the result of years of savings and loan responses to the trend in mortgage lending established by the FHA and VA, and the portfolio restrictions established by Congress.

The institutions fought back against these regulations by circumventing them to the extent possible. Since investment opportunities were still largely limited to mortgages by FHLBB regulations, and by tax regulation, the savings and loans began to enhance their services. The industry expanded operations into costly branch networks (Exhibit 2) and other customer amenities, thus causing operating costs to rise. Savings and loans expected that these enhanced services would lure back customer deposits. To further lure depositors, they began offering Negotiable Orders of Withdrawal (NOW accounts) which were in substance interest-bearing checking accounts. This strategy further increased operating costs and resulted in a severe profit squeeze for the industry.

EXHIBIT 2

Number of Savings Institutions and Their Branch Offices, 1960-1987[a]

	Savings Institutions Offices		
Year-end	Main	Branch	Total
1960	6,320	1,611	7,931
1965	6,185	2,994	9,179
1970	5,669	4,318	9,987
1971	5,474	4,961	10,435
1972	5,298	5,851	11,149
1973	5,170	7,036	12,206
1974	5,086	8,775	13,861
1975	4,931	10,518	15,449
1976	4,821	11,908	16,729
1977	4,761	13,087	17,848
1978	4,725	14,250	18,975
1979	4,684	15,508	20,192
1980	4,594	16,733	21,327
1981	4,298	17,495	21,793
1982	3,831	18,712	22,543
1983	3,645	18,635	22,280
1984	3,591	18,812	22,403
1985	3,535	19,186	22,721
1986	3,488	19,540	23,028
1987	3,408	19,664	23,072

[a]Source: U.S. League of Savings Institutions [1989, p. 56].

This profit squeeze was the beginning of the savings and loan debacle of the 1980s. As profits plunged, the net worth, or capital position, of the industry eroded making reserve requirements ever more difficult to maintain. This situation prompted the industry to pressure the Bank Board into extending its deadline to meet the 5% reserve requirements. In 1972, the Board responded by authorizing institutions to compute their reserves as a percentage of savings deposits averaged over a five-year period. As the earnings positions of the institutions continued to weaken, the industry trade organization, the U.S. League of Savings Institutions, petitioned Congress to reduce the reserve requirements. Congress eventually did this in the Depository Institutions Deregulation Act of 1980.

THE 1980s: DEREGULATION, EXPANSION, CRISIS, RE-REGULATION

The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 was the first in a series of ill conceived regulation attempting to repair the regulatory induced damage done to the savings and loan industry in the 1970s. The regulation of the 1980s was ill conceived for several reasons. First, deregulation of savings and loan liabilities (freeing interest rates on interest bearing deposits) preceded deregulation of investments, thus exacerbating an already volatile earnings situation. Secondly, regulators authorized the use of several accounting methods which obscured the true financial condition of the industry. Finally, a lack of communication and coordination among various government regulators created a regulatory environment of uncertainty and confusion about the role the institutions were to play as financial intermediaries. Details of how this confusion developed follows in the discussion of the regulatory events that occurred during the 1980s.

DIDMCA and Garn-St. Germain Act

The first of the regulatory changes in the 1980s, DIDMCA, authorized a phase out of Regulation Q deposit rate ceilings, thus allowing savings and loans to increase rates paid on deposits (liabilities). In addition, the law legitimized NOW accounts nationwide. Both of these provisions caused an increase in the institutions' cost of funds. Furthermore, the Act gave the Federal Home Loan Bank Board the authority to vary reserves (or capital) requirements for individual institutions between 3% and 6% of deposits. The Act also granted savings and loans some limited freedom to diversify asset holdings including the ability to invest up to 3% of assets in service corporations (i.e., subsidiary corporations allowed to participate in a wide range of business activities). These asset diversification powers were further expanded in 1982.

The 1982 Act, the Garn-St. Germain Depository Institutions Act, allowed savings and loans to invest up to 30% of their assets in consumer loans and corporate debt, up to 40% in nonresidential real estate, and up to 10% in commercial loans. In addition to these new investment powers, the Garn-St. Germain Act eliminated loan to value ratios on all loans (thus permitting 100% financing of real estate projects); and, for the first time,

permitted adjustable rate mortgages. Regulators believed that, collectively, these 1980 and 1982 changes would enable savings and loans to diversify some of their long-term lending and short-term borrowing financial structure and better weather changing economic conditions in the future.

This expectation may have proved true had the DIDMCA and Garn-St. Germain asset reforms been enacted a decade earlier, before the devastating interest rate spread losses in the 1970s. As it happened, upon entering the 1980s, savings and loan profits were at a historical low (Exhibit 1), and institutions may have lacked the capital to acquire investment expertise in many of the areas newly opened to them. Furthermore, reserves for some institutions were below the 3% minimum mandated by Congress in DIDMCA [Strunk and Case, 1988, p. 31]. Garn-St. Germain provided a *solution* to problem in the form of net worth certificates.

Beginning in September, 1982, the Garn-St. Germain Act allowed a pseudo-capital infusion for under capitalized institutions in the form of net worth certificates which the institutions purchased from the FSLIC. These certificates served to increase an institution's assets and equity for regulatory purposes, and basically provided for a semi-annual cash infusion to the institution by the FSLIC until such time as the institution returned to profitability.[9] These net worth certificates were not treated as capital by generally accepted accounting principles (GAAP).[10] This became the first in a series of GAAP versus RAP (regulatory accounting principles) differences which obfuscated analysis of the financial condition of savings and loans. Other such differences were deferral of loan losses and appraised equity capital, discussed below.

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[9]Net worth certificates were recorded as Notes Receivable-FSLIC and Capital. Under the arrangement the FSLIC paid interest on these notes semiannually to the institution "at rates equal to the yield on FHLBB obligations plus 25 basis points" [Peat Marwick Main & Co., 1988, Section 19.3.3]. The institution would then reimburse the FSLIC at the same rate of interest, "but interest is not due until the institution returns to profitability" [Peat Marwick Main & Co., 1988, Section 19.3.2].

[10]Per GAAP, the net worth certificates were treated as an off balance sheet item which was to be disclosed in footnotes, although interest accruals were made [Peat, Marwick, Main and Co., 1988, Section 19.3.3].

GAAP versus RAP

In order to buy time for institutions to restructure their portfolios in response to the new investment opportunities of DIDMCA and Garn-St. Germain, the FHLBB developed a series of optional accounting rules designed to bolster the appearance of net worth. The most prominent of these became the appraised equity capital provisions, and deferral of losses on the sale of loans.[11] Appraised equity capital arose from institutions recording the increase in the market value of the office buildings which they owned and occupied. During the 1970s, some institutions began to build net worth by selling their buildings, recording the gain, and leasing the facility back from the new owners. From November, 1982, to December, 1986 the FHLBB permitted all institutions to "book" this gain in market value, without actually selling the premises, calling it "appraised equity capital." This non-consummated transaction was not recognized by GAAP.

In contrast to this GAAP violation, a second FHLBB regulation challenged GAAP by deferring recognition of transactions that were consummated. This new provision allowed the deferral of losses on the sale of loans. By contrast, GAAP required recognition of these losses. However, in order to encourage institutions to sell off low interest bearing loans, the Bank Board allowed any such losses to be deferred and amortized over what remained of the original life of the loan. This regulation was in effect from October, 1981 to October, 1984. These two primary regulatory accounting techniques constituted the most blatant departures from GAAP; however, other differences also developed.

Other GAAP versus RAP differences developed because of aggressive interpretation of existing GAAP rules, special institution specific decisions made by the Bank Board, and a delay in the issuance of authoritative accounting literature by the Financial Accounting Standards Board (FASB). Some of these included the following. First, RAP allowed recognition of gains and losses on "wash sales" of securities sold and reacquired within a short period of time, while GAAP did not allow such recognition. Second, RAP allowed recognition of current income from loan origination and commitment fees up to 2% of

[11]Several less significant differences in GAAP and RAP which existed at this time are summarized in McEachern, 1986.

loan value, while GAAP required recognition of these fees as an adjustment to yield over the life of the loan using the interest method of amortization.[12] Third, RAP allowed use of real estate appraisals to satisfy GAAP requirements of net present value computations for valuation of real estate collateral on acquisition, development and construction loans. Fourth, for certain mergers of troubled institutions, the FHLBB allowed goodwill to be amortized over an extended period of time, while GAAP allowed such extensions only when a substantial amount of liabilities acquired were long-term in nature. In addition, for certain mergers including FSLIC cash assistance, RAP treated this as a contribution to capital, while GAAP generally treated this as a deferred revenue or discount on the assets for which the allowance was granted.[13]

Many of these GAAP verses RAP discrepancies were vehemently opposed by the accounting profession because of the potential for creating misleading financial statements. Several comment letters to this effect were written by the AICPA and the FASB to the FHLBB, the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives, the SEC, and various individual Congressmen.[14] Some of the comment letters were written as early as January, 1981 when the RAP rules were only at the proposal stage. Each letter detailed differences between the RAP treatment and the GAAP treatment (or proposed GAAP treatment), indicating the potential for distortion of an institution's capital position. The profession feared such distortions would then mask the true financial condition of the savings and loan industry.

These concerns from the accounting profession went largely unheeded, as evidenced by regulators' decision to allow RAP for reporting purposes. Furthermore, regulators allowed each institution to choose which set of accounting rules, GAAP or RAP, to follow in preparing its financial statements to be filed with the Bank Board. Not surprisingly, those institutions adopting RAP

[12]This GAAP treatment was not promulgated until issuance of *Statement of Financial Accounting Standards No. 19, Accounting for Nonrefundable Fees and Costs associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, in December, 1986.

[13]Details of these four GAAP verses RAP differences are described in McEachern [1986, p. S-48, S-49] and Peat Marwick Main and Co. [1988, Chapter 30.2 and 21].

[14]An extensive list of these communications is presented in Chenok, 1989, pp. 150 and 154.

were generally found to be the ones with lower capital ratios [Hill and Ingram, 1989]. Since institutions with low capital ratios were in danger of violating minimum net worth requirements, they could have been forced to merge or liquidate. For such institutions, the adoption of RAP served to postpone intervention by the FHLBB. This forbearance by the FHLBB has been cited as one of the factors contributing to the savings and loan debacle of the 1980s.[15]

Forbearance by the FHLBB should not, however, have been surprising, since the Board had behaved similarly in the crisis of the 1970s (as discussed previously) by manipulating capital standards. In doing this, the Board was conforming to its original legislative purpose established in the 1930s: to assure the uninterrupted flow of funds to the savings and loan industry. This original legislative intention assumed the primary purpose of savings and loans to be the supply of funds for residential mortgages. A broadening of the scope of the industry was, however, introduced in the new investment vehicles provided by DIDMCA and Garn-St. Germain legislation. The role of the FHLBB following these changes was not updated. This was only one of several conflicts in Congressional intent. Another conflict was manifest in the tax law.

Tax Reforms in the 1980s

The specific tax law provisions related to savings and loans remained virtually unchanged following DIDMCA and Garn-St. Germain. Despite the investment flexibility permitted under DIDMCA and Garn-St. Germain, the tax law still required savings and loans to maintain between 82% and 60% of their assets in qualified form (primarily residential mortgages). While still demanding this large commitment to residential mortgages, and even as industry profits sagged, tax changes made in 1982 and 1984 served to increase the tax burden placed upon the institutions. The tax changes increased the tax burden on savings and loans by reducing the percentage of taxable income bad debt deduction from 40% to 32% of taxable income.[16] This deduction was further reduced to 8% in the Tax Reform Act of 1986.

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[15]Pilzer, P., 1989; Pizzo, S., Fricker, M. and Muolo, P., 1989; and Adams, J., 1990 each discuss this problem at length.

[16]The Tax Equity and Fiscal Responsibility Act of 1982 added section 291, which provided that the deduction for certain preference items, including the bad debt reserves of savings and loans (to the extent they exceeded reserves

The Tax Reform Act of 1986 made two major changes to the percentage of taxable income bad debt deduction. First, the Act eliminated the sliding scale between 82% and 60% investment in qualified assets. This effectively reduced the minimum required investment to 60%. This change brought tax qualified assets into closer alignment with regulatory allowed assets for the first time since 1969. The second change reduced the deduction percentage from 32% to 8% of taxable income. Prior to the passage of this provision, Congress had contemplated the complete elimination of this deduction [U.S. Congress, 1983]. Thus, the savings and loan institutions became aware that they were losing their tax protection for performing their service to the mortgage market. At the same time, they were allowed more flexibility in structuring their portfolios. The message from Congress was consistent at this point: diversify and become fully taxable financial intermediaries. Some institutions acted quickly to diversify.

Expansion and Crisis

Some savings and loans began using new investment powers granted to diversify out of residential mortgages.[17] However, by the time these powers were granted in the 1980s, the industry had a severe net worth problem. The Bank Board, anxious to encourage an influx of new capital into the industry, dropped a long standing requirement that institutions have a minimum of 400 shareholders, with no one shareholder owning more than 25% of the savings and loan. After this policy change, institutions were eligible for 100% ownership by a single individual [Strunk and Case, 1988, p. 94]. This attracted a new type of owner/manager to the savings and loan business: mortgage bro-

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computed under the experience method), be reduced by 15% of the otherwise allowable deduction. At the same time, the amount considered a preference for the minimum tax computation was reduced to 71.6% of excess reserves [IRC section 57(b)(1) and (2)]. Assuming that the entire percentage of taxable income bad debt deduction addition to the reserve was in excess of the experience method, the applicable rate for the deduction was reduced to 34%. Next, the Deficit Reduction Act of 1984 reduced this deduction rate to 32% by increasing the IRC section 291 rate to 20% and also reducing the amount included in the minimum tax base to 59.833% of the excess. This reduced the bad debt deduction to 32% of taxable income.

[17]For a summary of empirical research documenting this diversification and its effects on profits, see Margavio, 1990.

kers and land developers who saw the opportunity to capture a source of financing for their investments and projects. "In both cases, an association charter now provided them [the new owners] with a lower cost and more certain source of funds than commercial bank borrowings" [Strunk and Case, 1988, p. 95]. In addition, the borrowings were federally insured by the FSLIC.

Federal insurance of depositor accounts by the FSLIC was the root of a risky investment strategy undertaken by many institutions that were desperate to build their net worth. If the big risks paid off, then the institution and its shareholders would benefit, but if risky investments did not pay off, the FSLIC would share in the loss of a collapse of the association. Some institutions invested extensively in junk bonds, and others increased interest rate hedging transactions to a level of gambling on the direction of future interest rates.[18] Institutions began investing heavily in ADC (acquisition, development, and construction) loans to fund the commercial and residential real estate development activity of the new owner.[19]

In order to attract funds to finance this activity, some institutions began offering interest rate premiums to depositors. This attracted a substantial amount of deposits from brokers outside of the institution's geographic area. Savings and loans were limited to obtaining 5% of deposits from this source. However, in March 1982, the restriction was removed by the Bank Board and billions of dollars flowed out of money market funds and into thrifts [Strunk and Case, p. 91, 92]. Institutions using brokered deposits began to grow at a phenomenal pace, further fuelling real estate development activity.[20]

Some thrifts became so extensively involved in funding real estate development activities of certain developers that the institutions became, in substance, equity partners. This was particularly true in the case of ADC loans. Accounting rules during this time allowed such loans to be classified as loans rather than direct investments, obscuring the true relationship between the

[18]Pilzer [1989] describes this strategy in Chapter 5, "The Gamblers," pp. 123-135; and in chapter 6, "The Man With the Lucky Coin," pp. 136-149.

[19]Pilzer [1989] describes this strategy in Chapter 4, "The Cowboys," pp. 80-122.

[20]Many institutions were growing at rates faster than 25% per year [Pilzer, 1989, p. 174].

institution and the developer.[21] In addition, many fraudulent appraisals were obtained to value the collateral land. In the early 1980, this problem was not discovered because real estate prices continued to rise. This spurred another problem. Some institutions became careless in granting credit to applicants under the assumption that if the loan went bad, increasing property values would cover the losses. Problems with these strategies surfaced in the Southwest beginning in late 1985 and early 1986 when a drop in oil prices caused a major economic recession. This was followed by a substantial decline in real estate prices; a problem which spread nationwide with the spread of the recession. In addition, by 1985 many markets began to show signs of overbuilding as office vacancies rose.[22] This condition was aggravated by 1986 tax changes which eliminated many tax benefits for real estate ownership.[23] Consequently, the number of failing institutions began to rise (Exhibit 3).

Both the FHLBB and the FSLIC were aware of the problem. They were, however, prevented from acting quickly to close the institutions because of a severely outdated regulatory structure and purpose. The historical purpose of the FHLBB examiners was to check for compliance with government regulations. This required little training since substantial regulatory changes were not often made. Consequently, examiner positions were filled by low level civil service employees. Examiners merely reported their findings to the Washington Office of the FHLBB; the examiners could not require establishment of reserves for loan losses, and had no other enforcement powers. Enforcement powers rested with the supervisory branch of the Federal Home

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[21]Subsequent to the publicizing of some of the thrift industry problems, the Accounting Standards Executive Committee of the AICPA issued (in February, 1986) a "Notice to Practitioners - ADC arrangements." This notice clarified stringent rules which must be met for classification of ADC loans as loans. Those arrangements not meeting the rules were required to be shown as equity investments. [Peat Marwick Main and Co., 1988, Chapter 6].

[22]The overbuilding was largely a result of the Economic Recovery Tax Act of 1981 which gave special tax breaks for investing in real estate. Investors seeking tax deductions formed highly leveraged tax shelter partnerships which overbuilt the real estate market. The leverage used in these real estate partnerships came in part from the savings and loan industry.

[23]These tax changes include passive investment loss limitations for investments in real estate; change in depreciation computations; at risk rules applied to real estate investment; investment interest limitations; and capital gains changes.

EXHIBIT 3

Failures of FSLIC-Insured Institutions[a]

Year	Number	Assets (In Millions of Dollars)
1980	11	$ 1,457.6
1981	28	11,553.4
1982	74	20,202.9
1983	55	19,741.8
1984	27	6,000.4
1985	49	18,441.3
1986	85	31,620.5
1987	71	20,918.1

[a]Source: Strunk and Case, 1988, pp. 8, 9.

Loan Bank which consisted of the president and a small staff at the regional FHLB level. This structure created delays in communications of problems and further delay in corrective action.

Once communication difficulties were overcome and a problem institution identified, the first step in taking action was for the regional FHLB to obtain a "consent decree." In this agreement, the thrift management would voluntarily discontinue specified transactions. If this failed, "cease and desist" orders and management removal requests were sought. These could only be issued by the Washington Office. They were difficult to obtain because they could be challenged in court, and required additional evidence of wrongdoing. Despite these shortcomings, the system worked until the deregulation of the 1980s added complexities to the business.

With the proliferation of new investments allowed in the 1980s, rapid market changes in the late 1970s, and the expansion of branch networks, the FHLBB examination staff was overextended and undertrained as to potential problems. Examinations of the institutions took more time and were conducted less frequently as problems mounted. Then the stories of the famous failures surfaced.[24] The FHLBB petitioned Congress

[24]The Empire Savings and Loan of Mesquite, Texas scandal become public information in 1983 when the owners became the subjects of an extensive FBI investigation for fraud, conspiracy and racketeering in various land flip deals [Pilzer, 1989, p. 115]. American Savings of Stockton, California received public

to tighten the regulatory reins to give the FHLBB power to act more quickly in "cease and desist" cases, and to provide funds to the FSLIC so that it could absorb projected losses from closing problem institutions.

Re-regulation

Congress responded with the Competitive Equality Banking Act (CEBA) of 1987, the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) of 1989, and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. These Acts provided a much needed infusion of funds (approximately $177 billion) to the FSLIC; and established the Resolution Trust Corporation, a temporary entity, to dispose of the assets of failed institutions. The Acts also changed the savings and loan regulatory structure by abolishing the FHLBB system. The FHLBB supervisory and examination functions were turned over to the Office of Thrift Supervision (OTS) [*Savings Institutions*, 1989, p. 32]. Responsibilities of the OTS were designed with greater emphasis on assessing the financial viability and asset quality of institutions. Thus, responsibilities more closely paralleled those of the Office of Controller of the Currency, the banking industry supervisory agency. The OTS was also given greater autonomy in requiring operating changes for, and ultimately, shutting down institutions judged to have too many risky investments.

In order for the OTS to perform this function effectively, objective measures of riskiness had to be established. A system of risk determination was structured for both individual assets, and for an institution's entire portfolio of assets. This system recognizes a strong connection between the quality of an institution's assets, individually and collectively, and how that quality improves or deteriorates the institution's capital posi-

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attention in 1984 when regulators forced out the CEO for betting wrong on interest rate swings and masking bad real estate loans [Pilzer, 1989, p. 216-219]. Vernon Savings and Loan of Dallas, Texas entered receivership in 1987 when 96% of its real estate loans were deemed worthless [Adams, 1990, p. 47]. Lincoln Savings and Loan of Irvine, California became a much publicized scandal in 1987 when news of its fraudulent real estate deals and ties to the "Keating Five" were revealed [Adams, 1990, p. 252]. Columbia Savings and Loan of Beverly Hills, California, and Franklin Savings Association of Ottawa, Kansas were exposed in 1988 for their huge portfolios of junk bonds and their relationship with Michael Milken [Pilzer, 1989, p. 136-149].

tion. Definitions of risk are, therefore, cast in terms of minimum capital standards required to sustain the institution's investment in certain types of assets. The definitions and capital requirements were borrowed largely from the three tier capital standards system used by the Office of Controller of the Currency. A brief overview of the composition of these tiers is presented below.

Tier one, core capital (or leverage capital), is defined as the sum of common stockholders' equity and noncumulative preferred stockholders' equity; plus identifiable intangibles (excluding goodwill and limited to 25% of total core capital); plus purchased mortgage servicing rights. Savings and loans must maintain this core capital at a level of 3% of total assets. In addition, a second tier, defined as tangible capital, must be maintained at a level of 1.5% of total assets. Tangible capital is defined as core capital (tier one) minus all intangible assets. Finally, tier three, known as risk-based capital standards, requires institutions to maintain reserves of 6% of risk-weighted assets and to increase this percentage for interest rate fluctuations that adversely affect earnings [*Savings Institutions*, 1989, p. 32; 12CFR Ch.V Part 567]. Each major category of assets is given a risk weighting factor which is multiplied by the dollar amount of assets in that category.[25] These risk factors are changed as market conditions dictate. There is a gradual phase in period until January 1, 1993 for the risk-based standards. As the standards are designed, savings and loans must meet the minimum capital criteria in each of the three tiers.

These standards are monitored by the OTS as savings and loans file the required quarterly financial statements. Effective January 1, 1994, these statements must be stated on a GAAP basis [Bush and Morrall, 1989, p. 30]. In addition to this return to GAAP accounting, the independent auditor now has a greater role in assessing institutional safety and soundness in the following ways.[26] First, institutions with over $150 million in assets are required to obtain annual audits. Second, in addition to traditional GAAP and GAAS (generally accepted auditing stan-

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[25]For example, Goodwill is generally given a 200% risk weight, thereby requiring a 12% reserve. Mortgage backed securities are given a 20% risk weight, thereby requiring a 3% reserve. Cash and federal government backed securities have a 0% weight, thus requiring no reserves.

[26]These provisions are summarized in *Journal of Accountancy*, March, 1992, p. 17.

dards) responsibilities, the audit report must comply with any additional disclosures that regulations require. For example, a separate report must be prepared attesting to management assertions that the institution is in compliance with regulations related to safety and soundness. Third, outside auditors must agree to provide workpapers to regulators upon request, and must notify the Federal Deposit Insurance Corporation (FDIC) if the auditor's services terminate. Finally, the FDIC may require that an institution's quarterly financial statements be subject to CPA review procedures. This authority of the FDIC stems from its new responsibility as the insuring agency for savings and loans.

In a massive reorganization of the insurance system, FSLIC merged into the FDIC, the insuring agency for commercial banks. This facilitated coordination of insurance goals, rates, and supervision philosophy between the thrift and banking industries. By shifting the insuring of savings and loans and by the creation of the Office of Thrift Supervision, Congress implemented a policy of regulatory equality for savings and loans and commercial banks.

As the recent restructuring of savings and loans suggests, the banking industry has been successful in its long time urging of parity between the banking and thrift industries. Since 1951, the Commercial banking industry lobbied for tax equality between banks and savings institutions.[27] These arguments were reiterated in hearings related to changes implemented in the percentage of taxable income bad debt deduction in the Tax Reform Act of 1986. Bankers perceived these 1986 changes to be a move towards tax equality. In addition, arguments in the tax hearings acknowledged that the deregulation Acts of 1980 and 1982 (DIDMCA and Garn-St. Germain) were perceived by both industries to be regulatory moves towards establishing investment equalities. Thus, a trend had developed towards increasing equality between banks and savings and loans. The regulatory equalities implemented in CEBA, FIRREA, and FDICIA could be viewed as the culmination of this equality movement, with one

[27]Banks perceived the percentage of taxable income bad debt deduction to be the single greatest advantage afforded by the tax law to savings and loans over commercial banks. In virtually every major tax hearing that opened discussion of this deduction (see U.S. Congress, House, Committee on Ways and Means, 1951, 1961, 1969, and 1986 and U.S. Congress, Senate, 1983), the banking industry lobbied for its elimination in order to allow more equitable competition between the two industries.

major exception which now subjects savings and loans to investment restrictions not required of banks.

The recent legislation implemented a new qualified thrift lender (QTL) test which restricts savings and loans to investing 70% of their portfolio assets in qualified assets. The definition of qualified assets is limited to mortgages and home equity loans, mortgage backed securities, and construction loans. Up to 15% of these qualified assets can include: investments in service corporations; loans to churches, schools, nursing homes and hospitals; and consumer and education loans (limited to 5% of portfolio assets) [*Savings Institutions*, 1989, p. 33]. Portfolio assets are defined as total tangible assets reduced by fixed assets and liquid assets. These definitions impose limitations on the investment freedom of savings and loans which are even more severe than the pre-1980 limitations. These restrictions have been criticized by the industry as being almost vindictive [Wilson, 1990, p. 22].

This QTL test constituted a very significant change in the three most recent laws which is contrary to the trend towards equality among competing financial institutions. It serves to force savings and loans to specialize in mortgages by restricting other investment activity. At the same time, FHLB membership was opened up to banks and credit unions; and commercial banks obtained the authority to acquire savings institutions. These latter regulatory changes further expanded the operating capabilities of banks and credit unions by giving them greater access to housing funds. These financial intermediaries can now compete with savings and loans for mortgages, and obtain optimally diversified portfolios. However, savings and loans are now statutorily prohibited from diversifying extensively. This situation may lead to a devaluation in the savings and loan charter in the future.

WHAT WILL THE 1990s BRING?

This devaluation has been predicted by some experts [McLean, 1991; Jacobe, 1990; *Savings Institutions*, 1990]. They argue that as a result of the 1980s debacle, savings and loans have a bad image problem to overcome. A viable way of overcoming this problem may be simply to change over from a savings and loan charter to a savings bank or commercial bank charter. Such a trend has already been observed in California savings and loans [*Savings Institutions*, 1990, p. 31] and institu-

tions formed after 1988 [*Savings Institutions*, 1990, p. 5]. This leads some commentators to predict the demise of the traditional savings and loan institution.

The function of the traditional savings and loan, making mortgage loans and holding them to maturity, is perhaps outdated. This conclusion rests primarily on the burgeoning secondary mortgage market which was developed and promoted by government sponsored enterprises such as Fannie Mae. This agency (and others like it) buys mortgages and repackages them into mortgage backed securities which are sold on the open market with varying maturities. Such securities are popular with investors because of a perceived federal guarantee. This has created an adequate supply of capital to the housing market despite the savings and loan crisis (see comments by Alfred A. Dellibova, Deputy Secretary of the Treasury in *Mortgage Banking*, 1991, p. 31). It has also served to integrate housing financing into the nation's overall capital market.

This development of the real estate loan marketplace may eventually usurp the traditional function of the savings and loan industry. However, some industry observers still see the need for a strong consumer-oriented banking industry which would include mortgage financing and some other types of consumer financing. In addition, as the economy improves and investors seek investment opportunities with higher returns, they may retreat from the mortgage backed security market. The savings and loan industry then may acquire a new function in the capital market, that of buying and holding to maturity mortgage backed securities.

A type of specialization strategy similar to this has been observed by some empiricists [Kaplan, 1988; Rudolph, 1988]. However, its effect on profitability has not been demonstrated consistently. Ultimately, carving out a market niche of some kind may be the key to continued viability of savings and loans, as well as other financial intermediaries. Thus, all financial intermediaries could focus on their managerial strengths in structuring a strategy anywhere from specializing in housing finance, to consumer lending, to becoming a completely "diversified financial supermarket" [McLean, 1991]. Such specialization decisions would then rest with management instead of Congress, and the industry as a whole could be more responsive to market changes. This flexibility could be effected by regulatory changes allowing a universal charter for financial intermediaries. This

development, with corresponding adjustments in the tax law, would be an appropriate culmination to the 1980s piecemeal trend toward equality. It would also assist Congress in synchronizing its goals for the financial services industry.

CONCLUSION

In conclusion, Congress has made major progress in the 1980s in equalizing the regulatory structure of the financial services industry. The savings and loan industry benefited from these changes by becoming better able to respond to changing market conditions. Many of these changes were, however, overdue corrections of poor legislation in the 1950s, 1960s and 1970s. Those regulations (specifically the imposition of Regulation Q, tax and regulatory portfolio restrictions, and overly generous loan-to-value ratios and mortgage terms) set the stage for the crisis the industry encountered in the late 1970s. The disintermediation crisis of the 1970s led to a severe net worth problem from which the industry was not given the opportunity to recover until DIDMCA, Garn-St. Germain and the Tax Reform Act of 1986. This net worth problem was a driving force in many of the irregularities that developed in the industry during the 1980s. Better timing and coordination of the diversification opportunities afforded by DIDMCA, Garn-St. Germain and the Tax Reform Act of 1986, combined with the FIRREA structural changes have reduced these irregularities. Attention to these past policy changes, however, is only useful in understanding the problems of today and for examining needed future policy changes.

In planning for the future, Congress must recognize that market conditions have integrated the housing finance function into the overall capital market structure. Therefore, designing a future for the savings and loan industry must involve a process of setting policy goals for the entire financial services industry. Legislation in the 1980s moved in the direction of equalizing opportunities for the thrift and banking sectors of the financial services industry. However, it stopped short of full equalization and a definitive policy statement. Once an integrated policy goal is established, legislators can then structure tax considerations, supervisory functions and other regulations to achieve these goals, while at the same time allowing the institutions the flexibility to respond to ever changing market conditions.

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