Regulatory Failure

A regulatory failure was the 1980's savings and loan crisis. Many savings and loans went bankrupt, and the federal government lost over $150 billion covering insured deposits.

Mismatched Assets and Liabilities

The business of the savings and loans was to take deposits and to make home-mortgage loans.

This short-term borrowing and long-term lending constitutes a mismatch of assets and liabilities.

Interest Rate Jump

The nominal interest soared during the period 1980-2.

In 1979 OPEC raised the world price of oil to $40 per barrel, which caused 14% inflation in 1980.

The high inflation caused the nominal interest rate to jump, and restrictive monetary policy was perhaps also a factor.

Loss of Net Worth

Like a bond, a home mortgage falls in market value when the market interest rate rises. The mortgage continues to pay low interest, even though other assets now pay more. The mortgage is worth less, even though it may be carried on the books of the bank at the unpaid principal.

To retain deposits, the savings and loans had to pay higher interest. The low interest from the mortgages was insufficient to cover the high interest on the deposits.

Zombies

Many saving and loans therefore had low net worth, even negative for some. Regulators allowed these "zombies" (alive but dead) to continue to operate.

(Some savings and loans operated as non-profit companies still had high net worth, as over the years they had chosen to use past profits to build up reserves.)

Capital Requirement Not Enforced

The savings and loans with low net worth did not meet the regulatory capital requirement, but the requirement was not enforced.

A factor in the non-enforcement was intervention by politicians with bank regulators.

Speculation

The zombies created an opportunity for leveraged speculation. One could buy a zombie for a low price and then speculate using the insured deposits. If the speculation were successful, the new owner would make a killing. If not, the losses would be borne by the government.

New Ways to Invest

New legislation gave the savings and loans new ways to invest. Whereas previously they could only make home mortgage loans, now they could buy corporate bonds (including junk bonds) and could make mortgage loans on commercial real estate (office building, apartments, shopping centers).

Boom and Collapse in Texas

The opportunity was exploited particularly in Texas. The high oil price caused an oil boom, and real-estate prices rose.

However the boom did not last, many of the investments by the zombies went bad, and the zombies went bankrupt.

Congressional Hearings

No Congressional hearings were ever held on the debacle, because the politicians did not want to be blamed.