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A COMPARISON OF THE 1980S AND 2008 FINANCIAL CRISES

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ABSTRACT

The 2008 subprime mortgage crisis was caused by many of the same factors as the 1980s Savings and Loan crisis. There were numerous, concomitant, interrelated forces that caused these two crises. Just as the government did after the Savings and Loan crisis, they passed legislation to prevent a future crisis: the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Many of the items in this bill were also in the regulations passed after the Savings and Loan crisis. This article studies the similarities between the causes of the 1980s and 2008 crises and the resulting regulations – noting those actions that worked and those that did not.

1. INTRODUCTION

The New York Times Headlines:

“What’s New in Real Estate Brokerage; A Gaggle of Gimmicks to Entice Buyers”

“Further Tight Credit Means Problems for Housing”

“Mortgage Defaults Increase”

“Study Finds Housing Crisis in Rural America”

“Banks’ Bad Real Estate Loans Spur Rising Worry of Failures”

“Inquiry Finds a Pattern in Mortgage Frauds”

“Fed is Wary on New Bank Products”

“New Securities Tied to Assets”

“Bonuses on Wall Street May Be the Fattest Ever”

“The Market Plunge: Upheaval in the Financial World – Investors’ Hopes Sink as Stocks Slip”

“U.S. Bailouts: Caution Urged”

“Chrysler Corporation’s \$1.5 Billion Bailout”

“Unemployment Increases to 10.4%”

“Oil Prices Surge on Open Market”

“Regulation of Banking on the Rise: Trend Reflects Necessity and Not Ideology”

Recent headlines? No! These poignant headlines are from 1979 – 1989! Similar headlines have been seen in recent years as the U.S. again faces challenges in the financial services industry and the economy that were faced during the savings and loan/banking crisis of the 1980s. The 2008 subprime mortgage crisis was caused by

many of the same factors as this 1980s crisis. The government's solution to this crisis was the same as before. Why did we not learn from our mistakes the first time? More importantly, did we get it right this time and will it avoid future catastrophes? During the 1980s crisis, 2,036 FIs failed, (1,097 commercial banks and 939 savings and loans (S&Ls)) from 1980 through 1989. Since January 1, 2008 through September 14, 2011, 406 FIs have failed. Respectively, these failures had no single cause. Rather, there were numerous, concomitant, interrelated forces that caused these two crises. These common causes include deregulation of the financial services industry, unexpected interest rates changes, lax and imprudent lending, fraud fueled by greed, changes in financial accounting procedures, derivative instruments, regulatory oversight failure, and a resulting housing market crash. It befits us to study the similarities between the 1980s and 2008 crises – noting those actions that worked and those that did not. Given the state of the economy, the question that arises is – can we prevent the past from repeating itself?

2. CAUSES OF THE 1980S CRISIS

Prior to 1980, the law (Regulation Q) limited the interest rates banks and thrifts could offer on savings deposits. From 1963 – 1979 interest rates on short-term savings and time deposits ranged from 3.91% to 11.22%, while 30-year mortgage rates ranged from 5.83% to 11.19%. During this same period, total deposits were consistently over 82% of total assets; while home mortgage loans dropped from a high of 86% of total assets to 69% of total assets. The comfortable positive interest rate spreads the S&Ls were enjoying in the 1960s began eroding in the 1970s. When the late 1970s inopportunistly ushered in double-digit market interest rates, the S&Ls experienced a disintermediation of deposits to other higher yielding investments such as money market mutual funds being offered by the banks. A liquidity crisis ensued for the S&Ls as Regulation Q limited what the S&Ls could pay on savings deposits. Legislation called the Depository Institution Deregulation and Monetary Control Act of 1980 (aka, DIDMCA) was designed to ease the disintermediation problem by lifting these interest-rate ceilings (DIDMCA, 1980). DIDMCA repealed Regulation Q and allowed S&Ls and banks to pay competitive market rates for deposits. DIDMCA additionally raised the FDIC insurance limit covering banks from \$40,000 per account to \$100,000; and it extended this same coverage to thrift institutions covered under FSLIC insurance. The Federal Savings and Loan Insurance Corporation (FSLIC) was granted the full faith and credit of the US government. This meant the federal government would guarantee deposits held in institutions with FSLIC insurance as well as FDIC insurance. The aim of this expansion of coverage was to enhance the safety and soundness of the financial system. Instead, it fostered “moral hazard” by troubled institutions. Moral hazard occurs when a FI engages in risky loans and investments; all the while knowing that in the event of failure, their customers' deposits are insured by the Federal Government (O'Brien, 1999).

Wall Street investment firms attracted by the government-insured, high-yielding certificates of deposits and savings accounts being offered by banks and S&Ls, hired deposit brokers to find the best available rates. The deposit brokers received commissions for placing the funds. S&Ls and banks could now attract a large number of deposits simply by offering the highest rate. To make a profit off these expensive borrowed funds, the FIs had to lend at even higher rates, making more, riskier loans. The Depository Institutions Act of 1982 (aka, DIA or Garn-St.Germain Act) was designed to further increase the competitiveness of the banking system by allowing S&Ls greater freedom to make other types of loans. These were loan types such as commercial, business, agricultural, dealer financing loans, and adjustable rate mortgages. This enabled them to expand their consumer loans portfolios. The intention was to allow S&Ls to charge higher interest rates on these loans to return them to profitability. During the 1960s and 1970s, home mortgage loans made up over 90% of S&L loan volume, while consumer and commercial loans comprised less than 10% of total loan volume. After the enactment of DIA 1982, S&Ls began making more non-mortgage, higher risk loans. Consumer and commercial loans increased to over 40% of the S&Ls' loan portfolio in the 1980s.

The large amount of money flowing into all FIs via brokered funds allowed the banks and S&Ls to boost their reserves and make increasingly larger and riskier loans. FIs paid huge bonuses and salaries to officers originating such loans; thus, the opportunity was ripe for fraud fueled by greed. Anxious to improve earnings for the FI, and for themselves, loan officers departed from their traditional lending practices and markets. Many ventured into credit markets offering higher returns and risks. Unfortunately, they were unfamiliar or had little experience with these markets. FIs made loans on bad deals such as residential real estate using inflated appraisals, commercial real estate development, casinos, jets, windmill farms, oil exploration firms, all of which were outside the S&Ls' areas of expertise (History 1997, Ch. 4, 180). The nation was also experiencing a commercial and residential real estate boom in the 1980s (Shiller, 2007). In an effort to take advantage of this economic surge, many S&Ls lent far more money than was prudent to risky commercial real estate ventures

which many S&Ls were not qualified to assess (Seidman, 1997). Total percentage of commercial real estate loans in an S&Ls' loan portfolio rose from 17.3% in 1980 to 38.1% in 1986 to 30.2% in 1989. In addition, because of the high interest rates and escalating home prices many families were unable to afford home purchases. In an attempt to qualify buyers for a residential mortgage, banks began increasing the debt payment to income ratio from the traditional 25% to 33% (Brooks, 1982). This upward movement was dangerous to unsuspecting borrowers!

In addition to the precarious changes in residential home ownership, the expected changes in the tax law combined with the glut of office space available began to depress commercial real estate prices (Bleakley, June 17, 1985). Prior to 1986, primarily passive investors provided the funding for commercial real estate ventures. The Tax Reform Act of 1986 reduced the value of these investments for passive investors by restricting the extent to which losses could be deducted against ordinary income (Auerbach & Slemrod, 1997). The Tax Reform Act of 1986 ended the benefits of this tax shelter and thus encouraged the holders of loss-generating properties to try to unload them, which contributed further to the problem of sinking real estate values (Auerbach & Slemrod, 1997). This contributed to the end of the real estate boom of the early to mid 1980s and facilitated the S&L crisis. Between 1986 and 1991, the number of new homes constructed dropped from 1.18 to 0.84 million and existing home sales dropped from 3.48 million to 2.87 million. Although home prices were still increasing during this period, they were doing so at a decreasing rate. The median price of new single-family homes actually decreased 1.90% in 1991. When both the commercial and residential real estate markets started their decline in 1986, the FIs went with them. From 1986 through 1991, 2,123 FIs failed (1,098 banks and 1,025 S&Ls). The government's increasing of deposit insurance coverage virtually guaranteed that desperate S&L owners and managers would engage in ever more risky investments, knowing that if they were successful, the institution would be saved, and if unsuccessful, their depositors would still be bailed out.

Homeowners began defaulting on mortgages in large numbers as early as 1979. Delinquencies were 2.79% of total loans in 1979, up from 0.62% the year before. Delinquencies reached their 3.88% peak in 1983. Loan charge-offs as a percent of total loans increased steadily from 0.27% in 1979 to 1.6% in 1991. The Mortgage Bankers Association reported a record number of borrowers had been delinquent 30-days or more and a still near-record number were losing their homes to foreclosure in the first quarter of 1985 (Kilborn, 1985). Experts cited the following factors as causes for the delinquencies: a high unemployment rate of 7.2%, a decline in the rate of increases in home prices, lax lending standards, and in some areas of the country, actual price declines in home values (Kilborn, 1985). The crashing of the stock market in October 1987 only made matters worse. DIDMCA and Garn-St.Germain acts introduced new risks and speculative opportunities for the troubled institutions. In summary, the elimination of regulations designed to prevent lending excesses and minimize failures backfired on the industry. The banking problems of the 1980s came primarily from unsound real estate lending (Seidman, 1997). Asset securitization, into which the financial industry now ventured, was another cause of the 1980's crisis. Loan participations, where S&Ls sold loans to other banks, allowed the S&Ls to spread their loan default risk to other institutions. Investment bankers like Goldman Sachs, Solomon Brothers, and Morgan Stanley were buying other types of loans secured by leases, automobiles, real estate properties, credit card receivables, and commercial properties from FIs. They then packaged them into collateralized debt obligations (CDOs), and sold them to investors (Bleakley, June 4, 1985; Bleakley, June 17, 1985; Sloane, 1985). The Federal National Mortgage Association (FNMA) also purchased first and second mortgages from the originating banks and thrifts, then packaged them into mortgage-backed securities (MBSs) and collateralized mortgage obligations (CMOs) which they sold to investors (Bennett, 1985). This securitization process made millions of dollars in new money available for more lending. The institution that generated the mortgages continued to service the loans and received substantial fees for doing so. MBSs and CMOs issues increased from \$452.4 million in 1970 to \$451,487.55 million by 1991. Novel risk-management techniques are also cited as a contributing factor to the 1980's crisis. The interest rate swap, a new technique to manage risk, was being used by many banks. Banking regulators grew concerned about these hedging devices, despite assurances by the bankers that the swaps were safe and that the banks' exposure was limited, (Bleakley, February 7, 1985).

Regulators failing to close insolvent institutions in a timely manner also exacerbated the crisis. Too many S&Ls were failing at the same time, the FSLIC was broke; and instead of cutting their losses and closing S&Ls who could not meet minimum capital requirements, the government lowered the minimum capital standards. This is like saying we have too few medical doctors, so let us lower the passing grade for becoming a licensed physician. In the hope of providing S&Ls time to recover, the Federal Home Loan Bank Board (FHLBB), the oversight board for S&Ls, lowered capital reserve requirements from 5% to 4% in November 1980 and to 3% in January 1982 (History 1997, Ch. 4, 173). When these measures failed to forestall insolvencies, the Garn-St.Germain Act of 1982 authorized a new capital assistance program – the Net Worth Certificate Program.

Under this program, the qualifying distressed institutions would record an asset and a corresponding capital account on their balance sheets:

Dr) Receivable from FSLIC
Cr) Net Worth Certificate

The Net Worth Certificate was included in regulatory capital, thus bringing the S&L in compliance with required capital reserve ratios. However, a major problem was that the receivable from the FSLIC was worthless because their funds were depleted (Garcia *et al.*, 1983). The FHLBB also encouraged healthier banks and thrifts to acquire these failing S&Ls. Changes in the accounting practice for “goodwill” were implemented to make such acquisitions more attractive for the acquiring institution (History 1997, Ch. 4, 174). In July 1982, the FHLBB changed the existing ten-year amortization restriction on goodwill to no more than 40 years. Goodwill is created when the purchase price exceeds the market value of the assets of the acquired thrift.

A brief synopsis of the example provided in History of the Eighties – Lessons for the Future (History 1997, Ch. 4, 174) follows:

Suppose a failing thrift has asset of \$100,000,000 and deposits of \$100,000,000 and \$0 equity. Upon being purchased, its assets are discounted to their fair market value of \$75,000,000. The liabilities usually remain at book value. For simplicity’s sake, the acquiring bank simply assumes the assets and liabilities of the failed thrift. The healthy bank records:

Dr) Assets (at current market value)	\$75,000,000	
Dr) Goodwill (shortfall)	\$25,000,000	
	Cr) Liabilities (at book value)	\$100,000,000

After the assumption, the goodwill is amortized as an expense over a set period. Amortizing the goodwill over ten years increases expenses \$2,500,000 per year; whereas, amortizing it over forty years only increases expenses \$625,000 per year, a boost to earnings of \$1,375,000 per year.

Since the FHLBB allowed goodwill to be included as an asset for regulatory capital purposes, amortizing it over a longer period of time increased regulatory capital, which was also favorable for the acquiring institution. Still, these steps were not enough. What followed were massive bank and S&L failures. Between 1980 and 1994, over 1,600 banks and 1,300 S&Ls were closed or received FDIC financial assistance. In retrospect, the government proved itself to be ill equipped to deal with the S&L crisis. The proponents of deregulation acknowledged that the laxer rules should have been accompanied by stricter supervision (Roberts and Cohen, 1990). The rate of bank examinations per billion dollars in assets dropped by 55% from 1980 – 1984 (Roberts and Cohen, 1990). The lack of effective audits of the S&Ls by public accounting firms and regulatory agencies spurred the crisis. Government regulators often ineptly oversaw the thrift industry and too often delayed intervention (Reinstein and Steih, 1995). Many institutions, which ultimately closed with big losses, were known as problem situations for more than a year (Reinstein and Steih, 1995). Losses could have been much less had regulators closed failing institutions sooner; but the regulators had adopted a policy of forbearance; that is, they postponed legal action hoping the situation would eventually cure itself. The FSLIC was penniless. Thus, insured depositors at insolvent institutions could not be repaid. The U.S. government and the taxpayers had to come to the rescue because of the sheer number and volume of losses. This was a clear example of systemic risk and allowing the industry to get “too big to fail.”

2.1. The Government’s Solution to the 1980s Crisis.

The U.S. Government’s solution to the 1980s crisis was twofold: taxpayer bailout and regulatory reform. A comprehensive study conducted by the U.S. Treasury resulted in two major acts: the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (aka, FIRREA) and the Federal Depository Insurance Corporation Improvement Act of 1991 (aka, FDICIA). The overall objective of these regulations was to resolve the current financial crisis with the ultimate goal of minimizing future taxpayer losses. The particular directives address five areas: 1) financial stability restoration, 2) regulatory structure reform, 3) regulatory supervision and enforcement powers, 4) consumer and investor protection, and 5) operations reform.

- Financial Stability Restoration

To restore economic stability, FIRREA established the Resolution Trust Company (RTC) to purchase the toxic assets of insolvent thrifts and banks and to dispose of them for whatever they were worth (FIRREA, 1989). FDICIA recapitalized the FDIC through government loans and higher FDIC insurance premiums (FDICIA, 1991). This act now requires a risk-based process for assessing FDIC insurance premiums and determining capital requirements; thus institutions holding riskier assets must pay higher insurance premiums and carry more capital (FDICIA, 1991). To enhance the safety and stability of the system, the FDIC increased insurance coverage from \$0 to \$100,000 for self-directed individual retirement accounts (FDICIA, 1991).

- Regulatory Structure Reform

FIRREA restructured the S&L industry by disbanding the FHLBB and replacing it with the Office of Thrift Supervision (OTS) (FIRREA, 1989). The FSLIC is renamed to the Savings Association Insurance Fund (SAIF) and moved under the auspices of the FDIC, which also controls the newly named Bank Insurance Fund (BIF) (FIRREA, 1989).

- Regulatory Supervision and Enforcement Powers

The scope of FDICIA, 1991 covered: 1) ceasing the regulatory practice of forbearance – in essence the “too big to fail” policy – by setting mandatory rules for regulators to take prompt corrective action at the hint of a bank problem, 2) allowing the Federal Reserve to step in earlier in the event of a bank failure, 3) requiring failed banks be closed using the least-cost method, and 4) requiring all federally insured depository institutions have an annual examination and follow stricter reporting requirements (FDICIA, 1991). To further augment the powers of the banking regulatory agencies, FIRREA allows regulators to restrict an institution's growth and activities, rescind contracts (including salary and employment), forcefully apply enforcement actions, and remove or prohibit certain personnel from engaging in banking activities on an industry-wide basis (FIRREA, 1989).

- Consumer and Investor Protection

Shoddy lending practices were curbed to protect consumers and investors. FIRREA established the Credit Standards Advisory Committee (CSAC) to review and monitor the credit standards and lending practices of insured depository institutions (FIRREA, 1989). Appraisers must now be licensed and State-certified. FIs that knowingly obtain appraisal services from a person who is neither licensed nor certified suffer severe civil penalties (FIRREA, 1989). FDICIA also established an Affordable Housing Program Office (AHPO) to aid qualifying families in home foreclosure circumstances by encouraging loan renewals and restructurings (FDICIA, 1991). More severe standards for extensions of credit secured by real estate or real estate construction projects were mandated (FDICIA, 1991).

Bank savings depositors are further protected by mandatory disclosures of interest rates, terms of account, and other information (FDICIA, 1991).

- Operations Reform

Additional reforms were directed at rectifying accounting, operational, and managerial shortfalls at banks. FIRREA toughened goodwill amortization from forty years to a mere five years (FIRREA, 1989). It also prohibited any financial institution not meeting minimum capital standards from increasing its deposit accounts through the services of a deposit broker (FIRREA, 1989). FDICIA further caps, to reasonable levels, the interest rate paid on brokered deposits (FDICIA, 1991). Lastly, FIRREA directed the Federal Financial Institutions Examination Council (FFIEC) to develop and administer risk management training seminars for bank managers (FIRREA, 1989).

It took over \$189 billion of taxpayer money to bail out failed S&Ls and recapitalized the FDIC insurance fund (FDIC Annual Report 2008). Because of the massive costs, the financial industry became more concerned about the “forbearance” and “too big to fail” issues. Banking regulators declined to close and liquidate large failing banks because they had no way to shut down a large institution with its numerous connections to other financial institutions without creating a financial panic (Cocheo, 1990). Therefore, the government established a special committee – the Deposit Insurance Reform Committee – to examine these issues and develop solutions (Cocheo, 1990). The government and the bankers agreed that “too big to fail” had to go because neither the country nor the industry could afford it (Cocheo, 1990). Although FDICIA 1991 was an attempt to eradicate these bad practices, the “too big to fail” norm did not cease. In fact, further deregulation allowed banks to grow ever larger and more complex.

3. CAUSES OF THE 2008 CRISIS

Elements of the 1980s crisis can be seen in today's disarray in the automotive industry, residential and commercial real estate, and the declining stock market. The 2008 crisis had many causes. One chief cause was the earlier deregulation of the banking industry. This allowed for the development of 'super-center banks'. A synopsis of these deregulating acts follows. The Community Reinvestment Act of 1977 (CRA) required financial institutions to meet the credit and deposit needs of the communities in which they were located, including low-income neighborhoods (CRA, 1977). Failure to receive a satisfactory CRA rating would restrict a bank's merger, acquisition and branching activities. Many banks used the CRA as an excuse to make subprime loans, saying they were simply serving their communities. Yet, the CRA specifically stated that loans were to be made in accordance with safe and sound operations and for banks not to make high-risk loans that might bring losses to the bank. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) permitted adequately capitalized and managed bank holding companies (BHCs) to acquire out of state banks, thus allowing inter-state banking (Riegle-Neal, 1994). Now banks could have branches in all fifty states if they so desired.

The Glass-Steagall Act of 1933 had effectively separated commercial banking from investment banking and other securities and insurance activities (Banking Act of 1933). This was enacted as a consequence of the 1929 stock market crash and the ensuing 1930s depression. The Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act aka, GLBA) effectively repealed the Glass-Steagall Act. GLBA allowed a financial behemoth to develop – the "financial holding company." The new financial holding companies (FHCs) were allowed to engage in underwriting and selling insurance and securities, conducting both commercial and merchant banking, investing in and developing real estate and other "complimentary activities." Super-center banks were created that became "too big to fail" because of all of their interrelated activities. Recall that a factor in the 1980s crisis was to increase FDIC insurance coverage for deposit accounts (DIDMCA, 1980). However counterintuitive this seems, the Federal Deposit Insurance Reform Act of 2005 (FDIRA) further raised insurance limits from \$100,000 to \$250,000 for self-managed retirement accounts (FDIRA, 2005). This act merged the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) into a single Deposit Insurance Fund (DIF) and empowered Federal Regulators to adjust, periodically, deposit insurance limits for inflation.

The 2008 subprime mortgage crisis began in 2003. Decreasing interest rates attracted homebuyers to the market stimulating a housing boom. This along with beliefs of ever-increasing housing prices turned this boom into an unsustainable bubble. Graph 1 (see Appendix) shows the trend in various mortgage interest rates from January 1986 through December 2010. Interest rates had dropped from the 7% to 9% range in 2000 to the 3% to 6% range in 2003, but then began rising in 2005. Graph 2 (see Appendix) shows the upward trend in home sales and home prices from 2000 to 2005. But then as mortgage interest rates began to rise in 2005, home sales and prices began to fall. Graph 2 (see Appendix) shows that, new and existing family home sales increased from 5.494 million units in 2000 to 7.460 million units by 2005, but then began declining. The median existing family home price was \$146,008 in 2000, rose to a high of \$221,883 in 2005, but then began declining. Many bankers and mortgage brokers, motivated by greed, participated in predatory lending. They enticed borrowers into securing mortgages that carried high fees and interest rates knowing the likelihood of foreclosure. Mortgage brokers who earned large commissions while bearing no risk were eager to make loans to people who had neither money nor sufficient income for paying back these loans. This desire for large commissions, even by making bad loans, was similar to the events of the 1980s.

Similarly, the bankers originating these loans laid off the risk by securitizing the loans and selling them to Wall Street investment banks. MBS issues increased over 373% from \$583,339.72 million in 2000 to \$2,764,288.11 million in 2003. These investment banks packaged them into mortgage-backed securities (MBSs) that they sold. Investors were only too eager to buy these AAA-rated securities backed by subprime mortgages. Unfortunately, the investors faced two unknown problems: 1) the credit ratings were inaccurate and 2) they were unaware of the types of mortgages collateralizing these securities. The mortgage qualification guidelines were relaxed in order to produce more mortgages and more MBSs. Lending standards all but disappeared. Lenders were offering more loans to higher-risk borrowers, making loans with a loan-to-value ratio of 100% or greater and accepting zero percent down loans (Kirchhoff and Keen, 2007). In 2005, 43% of first-time homebuyers purchased their homes with no-money-down loans, according to a study released by the National Association of Realtors (Kirchhoff and Keen, 2007). Normally, banks refused to finance home mortgages for people with poor credit history or no income. Now, proof of income was no longer needed; next, proof of employment was not required, and then proof of any assets owned became unnecessary. Mortgage underwriting standards declined precipitously owing to the use of automated underwriting systems that allowed loans to be made without appropriate review and documentation (Browning, 2007). Automated underwriting systems used by the now

defunct Countrywide Financial allowed them to double their monthly subprime loan approvals in 2004 (Ward, 2004; Browning, 2007). In 2007, 40% of all subprime loans resulted from automated underwriting (Browning, 2007).

Bankers also became very creative in the types of loans they offered: no-money down loans, interest-only loans, adjustable-rate mortgages (ARMs) with attractive teaser rates, and payment option loans. An estimated one-third of ARMs originated between 2004 and 2006 had 'teaser' rates below 4% (Arnold, 2007). Unrealistically low interest rates, effortless credit, combined with a conviction that home prices would continue to escalate, enticed many subprime borrowers to obtain these adjustable-rate mortgages. These rates increased significantly after some initial period, as much as doubling the monthly payment (Arnold, 2007). Borrowers who could not make the higher payments tried to refinance their mortgages. Unfortunately, refinancing became more difficult. The resulting housing market pressure was increasing even more as home prices had begun to decline. Table 1 (see Appendix) provides a conservative example of what happened to monthly payments when mortgage interest rates reset after the ARM lock-in period expired. Using a 2003 median home price of approximately \$178,000, zero percent down, and a 30-year-3-1 ARM rate of 3.75% in June 2003, the monthly principal and interest payments are approximately \$824. After 3 years, the borrower has two options: 1) allow the interest rate to reset to the 1-year ARM rate, or 2) refinance into a 30-year fixed rate mortgage (FRM). If the borrower allows the rates to reset to the 1-year ARM rate, monthly mortgage payments increase over 27%. Of course, the reset rate could have been higher or lower depending on the loan terms. The other choice for the borrower is to refinance into a 30-year FRM at 6.82%. Unknown to many subprime borrowers, prepayment penalties from 1% – 5% were buried in the original loan documents. Assuming a 3% prepayment penalty is rolled into the amount to be refinanced, monthly mortgage payments increase almost 37%.

Bankers and mortgage brokers are not the only ones to blame for the subprime fiasco. The public took advantage of these absurd lending scenarios. Mortgage fraud by borrowers also increased enormously. In 2006, as much as 70% of defaulting loans had fraudulent misrepresentations by the borrowers on their original loan applications (Cowen, 2008). Borrowers grossly overstated their incomes and falsified documents; while, the loan officers failed to insist on adequate documentation of income and collateral before approving the loans (Cowen, 2008). Easy credit and escalating house prices had also led to a building boom and eventually to a surplus of unsold new homes, which caused U.S. housing prices to peak in mid-2006 (Shiller, 2007). By September 2008, average U.S. housing prices had declined by over 20% from their mid-2006 peak (Shiller, 2007). Median home prices declined approximately 22% from 2006 to 2009. Consequently, this major decline in home prices left many borrowers with zero or negative equity in their homes, meaning their homes were now appraising at less than their mortgages. As of March 2008, an estimated 8.8 million borrowers — 10.8% of all homeowners — had negative equity in their homes (Andrews and Uchitelle, 2008). The stock market crash in October 2007, the ensuing recession, rising unemployment, falling house prices, and stricter credit standards were making it impossible for these borrowers to refinance out of the ARMs into a fixed-rate loan (Arnold, 2007). Consequently, many borrowers defaulted on their loans or simply walked away leaving the houses to the banks.

As foreclosures increased, the supply of homes for sale increased. Loan delinquencies in 2006 increased from 1.32% of total loans to 3.49% by 2010. Loan charge-offs in 2006 increased from 0.393% of total loans to 2.665% in 2010. This supply outstripping demand forced housing prices to decrease even further. Housing prices declined between 6.06% and 11.89% in 2009. MBSs backed with subprime mortgages lost most of their value. Accounting standards required that these MBSs be marked down to their current market value. The result was a significant decline in the regulatory capital of FIs, which held these MBSs in their investment portfolios. The 1980s scenario was being replayed. A continuing contributor from the 1980s was the further development of swaps to manage risk. Basically an insurance policy, the credit default swap (CDS) appeared on the scene. The buyer of a CDS makes regular premium payments to the seller, for coverage in the event of a loss on the debt instrument insured. Many institutions who owned subprime mortgage-backed securities had purchased CDSs from American International Group, Inc. (AIG); thus guaranteeing that if the MBSs became worthless AIG would repay to them their lost principal. When so many MBSs became worthless, AIG did not have the cash or capital to make good on its insurance promises.

Another cause of the 2008 crisis, like the 1980s, was a failure of the various regulatory bodies (e.g., OTS, OCC, FDIC, Federal Reserve, SEC, etc.) to adequately police the industry. Regulators failed in three ways: 1) when deficiencies found at an institution were asked to be corrected by the institution, the regulators failed to follow up and make certain that those deficiencies were indeed corrected; 2) regulators failed to impose formal enforcement action as required by law; and 3) regulators relied too much on the institutions to track their own

corrective progress. A solution to the 1980s crisis was FDICIA of 1991, which required stricter capital ratios. Regulators, unfortunately, placed undue reliance on bank capital ratios, and failed to monitor other things. For example, several banks were “well capitalized” (like WAMU) in the call report the quarter before their closing (Sisk, 2009). The current financial crisis has highlighted the importance of strong, prompt oversight to help ensure the safety and soundness of financial institutions.

3.1. The Government’s Solution to the 2008 Crisis.

Like the U.S. Government’s solution to the 1980s crisis, its solution to the 2008 crisis was twofold: taxpayer bailout and regulatory reform. Two acts, the Emergency Economic Stabilization Act of 2008 (EESA) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), were ratified with the express intentions of resolving the current financial crisis, protecting consumers, and minimizing future taxpayer losses. Many of the provisions in these two acts were the same as those in FIRREA and FDICIA. Once again, the particular directives can be categorized with regard to the same five intentions as before: 1) financial stability restoration 2) regulatory structure reform, 3) regulatory supervision and enforcement powers, 4) consumer and investor protection, and 5) operations reform. The major provisions of these acts are as follows:

- Financial Stability Restoration

To prevent a collapse of the entire financial system, Congress enacted measures similar to those enacted to deal with the 1980s crisis. First, Congress provided \$700 billion to the Treasury Department’s Troubled Assets Relief Program (TARP) to purchase toxic credit securities and loans, such as subprime MBSs, from troubled financial institutions (EESA, 2008). EESA also authorizes the Secretary of the Treasury to deposit into the Treasury all revenues and proceeds from the sale of these troubled assets (EESA, 2008). TARP’s functions are similar to those of the RTC established in 1989 to deal with insolvent thrifts. EESA further allows the US Treasury to inject capital into banks to enhance lending. In exchange for loans or TARP money, the Treasury holds an interest in the bank in the form of dividend paying preferred stock, which can be included in the bank’s Tier 1 capital (EESA 2008). Additionally, the EESA temporarily increased FDIC insurance to \$250,000. This increase became permanent with the Dodd-Frank Act of 2010. As has been seen many times before, this action was taken to allay depositors’ fears about the safety and soundness of the financial system.

- Regulatory Structure Reform

A solution to the 1980s crisis was a restructuring of the financial services industry. Another attempt is made at restructuring the industry in an attempt to resolve the current crisis and to prevent future ones. The elements of this restructuring proposed by EESA and Dodd-Frank follow:

- Establishes the Congressional Oversight Panel to review and report to Congress on the status of the financial markets and regulatory system (EESA, 2008).
- Establishes the Office of the Special Inspector General for TARP to conduct oversight of the purchase, management, and sale of assets by the Secretary, including the management of any program established under this Act (EESA, 2008).
- Restructures the bank and thrift industries by abolishing the OTS and transferring its powers to the Office of the Comptroller of the Currency (OCC) (Dodd-Frank, 2010).
- Creates the Federal Insurance Office to examine insurance-related operations of financial entities (Dodd-Frank, 2010).
- Creates the Financial Stability Oversight Council (FSOC) consisting of heads of all regulatory bodies and chaired by the Secretary of the Treasury. The FSOC’s purpose is to identify and respond to emerging financial system risks posed by large, complex companies and products before they can threaten the nation’s economic stability. It recommends to the Federal Reserve strict rules for capital, leverage, liquidity and risk management as companies grow in size and complexity. It also has the power to break up a company if that company threatens financial stability of the economy (Dodd-Frank, 2010).
- Creates Office of Financial Research to collect data and conduct research on: 1) system-wide systemic risk levels, 2) improvements in risk management techniques, 3) disruptions and failures in the financial markets, and 4) other matters requested by the FSOC (Dodd-Frank, 2010).
- Establishes the office of Credit Ratings at the SEC to oversee Nationally Recognized Statistical Ratings Organizations (NRSRO) such as Moody’s, Standards & Poor’s, etc. It requires NRSROs to disclose their

methodologies and ratings track record, and to be examined annually by the SEC. Ratings analysts must pass qualifying exams and maintain continuing education. NRSROs can be held liable for reckless ratings. The SEC can deregister a NRSRO if it provides bad ratings over time (Dodd-Frank, 2010).

- Regulatory Supervision and Enforcement Powers

Many of the provisions below are similar, if not the same, as those enacted by FIRREA and FDICIA. Regulators, once again, are being reminded to perform their duties and enforce current regulations as well as new ones. Dodd-Frank requires examiners to take prompt corrective action to resolve problems of FHCs and to liquidate those that threaten the financial stability of the economy (Dodd-Frank, 2010). The “too big to fail” policy is to be permanently laid to rest. Taxpayers will nevermore bail out failed companies. Failing financial companies are expected to be resolved through the bankruptcy process (Dodd-Frank, 2010). To discourage companies from getting too big or too complex, Dodd-Frank imposes tough capital and leverage requirements. For example, for FHCs that are not well-capitalized, regulators may restrict growth, impose higher capital standards, limit debt to equity ratios to 15:1, and restrict executive compensation among other constraints (Dodd-Frank, 2010).

The new legislation is an attempt to roll back the liberties of GLBA and Riegle-Neal. Large, complex financial companies must prepare dissolution plans or “funeral plans” for their rapid and orderly shutdown should the company go under (Dodd-Frank, 2010). Plans are to aid regulators in understanding the structure of the companies they oversee and serve as a roadmap for shutting them down if the company fails. Failure to submit acceptable funeral plans can result in higher capital requirements, restrictions on growth and activities, divestment, and monetary penalties (Dodd-Frank 2010). Recall that the Riegle-Neal Act of 1994 permitted both well and adequately capitalized and managed BHCs to expand via mergers and acquisitions. Now, Dodd-Frank only allows well capitalized and well managed BHCs to expand via mergers and acquisitions (Dodd-Frank, 2010).

- Consumer and Investor Protection

Shoddy lending practices are once again being curbed to protect consumers and investors. EESA establishes the Financial Stability Oversight Board (FSOB) to assist families in preserving home ownership, stabilizing financial markets, and protecting taxpayers (EESA, 2008). It further authorizes the Treasury Secretary to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures (EESA, 2008).

Dodd-Frank establishes the independent Consumer Financial Protection Bureau (CFPB) to protect consumers from abusive credit practices. This new bureau makes and enforces laws intended to ensure the fair, equitable and nondiscriminatory access to credit. The bureau will oversee the new Office of Financial Literacy (OFL), which will develop educational programs for consumers (Dodd-Frank, 2010).

Lastly, Dodd-Frank mandates that issuers of MBSs and other asset-backed securities will not be able to shop around and pick the NRSRO agency they think will give them the highest rating. It requires issuers to disclose more information about the quality of the underlying assets and maintain an economic interest in that asset (Dodd-Frank, 2010). Likewise, banks must use independent third-party appraisers for certain government-insured loans.

- Operations Reform

Once again, there are additional reforms directed at rectifying accounting, operational, and managerial shortcomings. FIs receiving TARP monies are subject to limits on executive compensation during the period the U.S. Treasury holds an equity or debt position in them (EESA, 2008). EESA also suspended applying the Financial Accounting Standards Board Statement Number 157 (about fair value accounting) to financial and depository institutions. However, fair value accounting for all financial institutions was reinstated September 27, 2008.

Other safeguards include:

- Limiting a company’s trading in certain financial instruments, such as hedge funds and private equity funds, with its own money and for its own accounts; i.e. proprietary trading (Dodd-Frank, 2010).
- Requiring companies engaging in hedge funds, derivatives, and asset-backed securities, to have a vested interest or “skin in the game.” It requires them to retain at least 5% of the credit risk (Dodd-Frank, 2010).

- Bringing transparency and accountability to the derivatives markets by giving the SEC and Commodity Futures Trading Commission (CFTC) the authority to regulate all over-the-counter (OTC) derivatives, requiring that OTC derivatives be traded on an open exchange. Furthermore, parties in swap transactions must have adequate capital to meet future responsibilities (Dodd-Frank, 2010).
- Eliminating predatory lending practices. Lenders must ensure that borrowers have the means to repay loans. It also prohibits pre-payment penalties on loans and requires a worst case scenario disclosure on ARMs (Dodd-Frank, 2010).
- Giving shareholders a voice on executive compensation. Requires disclosures by SEC listed companies comparing executive compensation with stock performance over a five-year period (Dodd-Frank, 2010).
- Allowing interest to be paid on business checking accounts (Dodd-Frank, 2010).

4. CONCLUSION

In 2009, Bloomberg estimated the current bailout could potentially cost the U.S. taxpayers over \$9.7 trillion (Pittman & Ivry, 2009). Once again the government has decided “too big to fail” must go. But will it?

Why did the government bailout some institutions and not others? In hindsight, allowing Lehman Brothers to fail was not a good idea because its failure led to the collapse of other institutions. Angela Knight, chief executive of the British Bankers’ Association concurs:

“ . . . , if Lehman had not collapsed the shock to the global economy and the world financial system would possibly not have been as great as it was. The world financial system may not have suddenly come to a halt and the government interventions that had to follow may not have had to have been quite as big as they were. You have to remember that when Lehman Brothers collapsed, everything came to a complete halt. Financial markets stopped. If they had intervened there would have been the ability to handle the issues that were created by Lehman Brothers over a longer period of time. The subsequent crisis might not have been as bad and the losses as a result of it might not have been so great.”

George Magnus, senior economic adviser for USB believes: “The only question surrounding the failure of Lehman’s a year ago is how, not whether, it should have been allowed to fail. Because we know that its failure precipitated the closest thing to a systemic banking collapse any of us have seen, it is clear that the authorities got their decision badly wrong.” The government was unaware of the many microscopic linkages between various financial companies. Because of deregulation, FHCs had become so big and so inter-related that once one failed, they all started to crumble – the contagion effect of systemic risk. Under our current system, letting banks fail, as opposed to seizing and restructuring them – is a bad idea for the same reason that it is a bad idea to stand aside while office buildings in the City of Chicago burn in a fire. In both cases, the damage has a tendency to spread. In the 1930s, the U.S. government stood aside as banks failed; the result was the Great Depression. In the 1980s, regulators did not step in soon enough and over 2,800 banks/thrifts failed at a tremendous cost to the taxpayers. In 2008, the U.S. government stood aside as Lehman Brothers imploded. Within days, credit markets had frozen and the stock market plunged into an abyss. Once again legislation has been passed to prevent a future crisis reoccurrence. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 reiterated and refreshed needed action such as, putting an end to the “too big to fail” policy, protecting consumers against unethical lending practices, and enforcing regulations. Other items in this bill are new. Overall, the government is trying to get back to the basics of protecting consumers and investors. Will we get it right this time? Let us hope so. The question remains: have we learned anything from our financial mistakes or will we be doomed to repeat them? Only time will tell. In this particular case, history shows us that the U.S. has not learned from their mistakes. The government tends to be more reactive than proactive.

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Appendix of Tables and Graphs

Sources of Tables and Graphs may be found at the end of this Appendix.

	Initial Loan	Reset Option 1	Reset Option 2
	30-year-3-1-ARM at June 2003	30-year-1-ARM at June 2006	30-year-FRM at June 2006
Median home price (see Graph 2)	\$178,000		
Down payment	\$0		
Loan balance	\$178,000	\$167,802	\$172,836 **
Prepayment penalty 3%	n/a	n/a	\$5,034 *
Future value	\$0	\$0	\$0
Number of years	30	27	30
Annual interest rate (see Graph 1)	3.75%	6.06%	6.82%
Monthly payment	\$824.35	\$1,053.35	\$1,129.06
\$ change in payment		\$229.01	\$304.72
% change in payment		27.78%	36.96%

Sources for Tables and Graphs:

Graph 1: Graph is created from data found at various websites. Mortgage interest rates may be found at http://www.hsh.com/mortgage_rate_trends/National/ and <http://www.federalreserve.gov/releases/H15/data.htm>. Inflation rates may be found at <http://www.usinflationcalculator.com/inflation/historical-inflation-rates/>. Note that not all rates available for all years.

Graph 2: Graph is created from data provided by K. Fears at realtors.org; and data found at the U.S. Census Bureau, "New Residential Construction" found at http://www.census.gov/compendia/statab/hist_stats.html. Not all data available for all years.