The Greatest Stedilnica Crisis in History

By Sam Vaknin, Ph.D.

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A crisis the size of the TAT crisis, is, inevitably, political. It involves thousands of citizens, many decision makers from every walk of life and the very economic and financial fabric of the country.

But, the TAT crisis pales in comparison with other, similar, crises in other countries in the world.

In Israel in 1983, ALL the banks collapsed on ONE October day, for instance!

The biggest crisis of savings and loans institutions (=Stedilnicas) in history happened in the USA in the years 1986-1987.

A Savings and Loans Association (SLA), or a THRIFT, was a strange banking hybrid, very much akin to the Building Societies in Britain. On the one hand, it was a sort of a bank, allowed to take in deposits. On the other hand, it was allowed to land money only to current or prospective homeowners on the basis of a mortgage on their house. It was really a mortgage bank and only that. This limitation on the nature of their asset portfolio, increased the risk associated with their lending. The SLAs could not diversify their portfolio into other kinds of assets and so were exposed to the vicissitudes of the residential real estate markets in their respective regions. Sure enough, when the real estate markets experienced a normal business cycle slump, the SLAs were disproportionately affected. Regional economic shocks (such as down spiralling commodity prices) rocked the value of real estate and the stability of these lending institutions. The coup de grace was delivered through the inordinately volatile interest rates. SLAs had to pay short term depositors high interest - while collecting lower income, in the form of interest payments on their old loans. This negative spread between the cost of funds and the assets' yield - eroded the operating margins of the SLAs. When they discovered that the securities that they were holding were much less valuable than the loans that they were intended to secure - panic ensued.

Hundreds of thousands of depositors crowded to draw their funds. Hundreds of SLAs (out of a total of more than 3,000) were rendered insolvent, unable to pay their depositors. They had to shut up their gates and were put to siege by angry - at times, violent - clients who lost their life savings.

The illiquidity spread like fire. One stedilnica after the other collapsed, leaving in their wake major financial crises, ruined businesses and homeowners, devastated communities. The crisis reached gigantic proportions and threatened the stability of the whole banking system all over the USA.

The Federal Savings and Loans Insurance Corporation (FSLIC) - which insured the deposits in SLAs - could no longer pay the claims and, in effect, went bankrupt. This single event had a chilling effect on the Federal government. True, the government did not guarantee the obligations of the FSLIC. Still, it was perceived to be an arm of the Federal Government and the public shock and outrage were beyond description.

So, the Federal Government was forced to step in. A hasty $300 billion (!) package was put in place to save what could still be saved. This was the first step, a right and proper reflex: the injection of liquidity through a special agency, the FHFB. Everyone involved postponed the mutual accusations, the criminal charges, the resignations and recriminations to a later stage. First and foremost the system had to be stabilized and it could be stabilized only through the restoration of public trust. Public trust could be restored only with money - and with a lot of it. The visible, unambiguous involvement of the top level authorities had a positive, long term effect. The "full faith and credit of the USA" was now behind the SLAs and that was good enough for everyone.

Now, that the storm was over, it was time for more farfetched, structural changes.

First, the supervision of banks and banking operations was taken from the Central Bank, the Federal Reserve. This separation of functions was long overdue: the Central Bank can hardly be expected to supervise a game the rules of which it dictates. There was bound to be a bias in its analysis of its "clients" (not to mention the close personal relationships fostered in years of common work).

Thus, the following complex structure emerged:

The Federal Deposit Insurance Corporation (FDIC) operates the Bank Insurance Fund (BIF) and the Savings Associations Insurance Fund (SAIF), separate insurance funds for banks and SLAs.

Banks pay premiums at one rate to BIF - SLAs pay at another to SAIF.

FDIC is designed to be independent in two ways. Its money comes from premiums and earnings of the two insurance funds, not from Congressional appropriations. Its board of directors has full authority to run the agency. The board has laws to follow, but no boss.

The FDIC regulates banks and SLAs with the aim to avoid insurance claims by depositors. When an institution becomes unsound, the FDIC can lend it money or take it over. If it takes over, it can run it and then sell it as a going concern. It has the authority to close it, pay off the depositors and try to collect the loans. Often the borrowers cannot pay, so the FDIC ends up owning collateral for loans, say real estate and trying to sell it.

The Resolution Trust Corporation (RTC) is a direct result of the SLAs scandal. Prior to

1989, SLAs were insured by the now-defunct FSLIC. The FDIC insured only banks. Congress had to eliminate FSLIC and put the insurance of SLAs under FDIC. Still, a great number of SLAs were regarded as "special risk" cases. They were given over to the jurisdiction of the RTC. It took over SLAs that failed under FSLIC and later - until August 1992. It operated and sold SLAs - or paid depositors and closed the relevant SLAs (just like the FDIC does). The money to finance the RTC came from bonds sold by a new government corporation (Resolution Fund Corporation, RefCorp). RTC ceased to effectively operate last year.

The Office of Thrift Supervision (OTS) was also established in 1989 and it also supervises SLAs.

This used to be the function of the Federal Home Loan Board (FHLB), which was dismantled by Congress in 1989. OTS is a department within the Treasury Department, but law and custom make it practically an independent agency. It supervises around 1500 thrifts with assets of circa 1 trillion Dollars.

The Federal Housing Finance Board (FHFB) regulates and examines SLAs - but with emphasis on their liquidity. It aids their financial stability through lines of credit from twelve regional Federal Home Loan Banks (FHLB). Those banks and the thrifts make up the Federal Home Loan Bank System (FHLBS). Many FHFB regulations are intended to make sure that SLAs lend for housing - the reason that Congress created this bank-like system, separated from the banks.

FHFB gets its funds from the System and is independent of executive branch supervision.

A host of other supervisory and regulatory agencies and treasury departments is involved in the American banking system. But at least one thing was achieved: a clear, streamlined, powerful regulatory hierarchy. SLAs (and banks, for this matter) utilized the confusion generated by the overlapping areas of activity and authority of the numerous previous agencies. No one agency had the full picture. Now, all became obvious: insurance was the FDIC's job, supervision was the OTS's and liquidity was the realm of the FHLB. This may, arguably, be the biggest benefit which stemmed from this, otherwise, nerve - wrecking crisis.

The process was not devoid of mistakes. Healthy thrifts were coaxed and cajoled to purchase less sturdy ones. This weakened their balance sheets considerably and the government reneged on its promises to allow them to amortize the goodwill element of the purchase over 40 years. Despite all this, the figures are unequivocal:

Thrifts numbered 2,898 in 1989. Six years later, their number shrank to 1,612 and it is forecast to go down to less than 1,000 at the turn of the millennium. A process of consolidation is evident: SLAs merge, become bigger, stronger, better capitalized. They resemble banks, in this sense.

This last development was so overwhelming, that Congress decided to demand that each SLAs should have a bank charter by the year 1998. Paradoxically, the very success of the SLAs in healing themselves led to their elimination. Why have two kinds of banks if all the operational parameters are equal? Why use two names, two separate insurance and supervision bureaucracies and two sets of regulations to monitor and regulate essentially the same kind of entities? This was absurd. While in the height of the crisis the ratio of the SLAs equity to their assets was less than 1% - it reached almost 10% (!) in 1994 - better even than banks.

This remarkable turnarounds (one of the most stunning in human financial history) was brought about by serendipity as much as by careful planning. Interest rate spreads became highly positive (SLAs were able to collect interest - for, instance, by investing in government securities - which was much higher than the interest that they paid for their sources). The stock exchanges soared and enabled the SLAs to offer new stock at excellent prices. This, together with the persistent pruning of the weeds in the field of good SLAs, with downsizing of the bloated bureaucracies of the SLAs and with the on going consolidation process - led to the revitalization of these banking institutions.

The overall banking markets shrank as other types of financial intermediaries joined the fray - but the health of the SLAs was guaranteed.

As this new found health became more and more evident, the legislative bodies eased up. Congress began to implement the gradual repeal of the draconian Glas-Steagall law (which forbade banks from dealing with a whole range of financial activities). They realized that the more diversified the financial institution is - the healthier it is likely to be. Limiting a bank to certain types of assets or to a certain geographical location was dangerous. Congress began, therefore, to lift these restrictions.

One element need not be neglected in this discourse: the relative absence of political intervention in the handling of the crisis. It was managed by the Federal Reserve - an able, utterly professional, blatantly a-political body. This is the most autonomous central bank in the world. It is never afraid to face the two biggest powers in the world: the President of the USA and Public Opinion - and it does this often. It thrives not on conflict but on the proper, impartial management of the economy.

This, by all means, is the biggest lesson to be learnt.

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Crisis Management Tips
by: **Colin Ong TS**

The term crisis management has different connotations. In this article, I will try to provide pointers that can be used in most situations:

Is It A Crisis In The First Place?:

This question is important to ask, as there are many situations that go wrong because the right person to handle it is not around. You may be in charge of a project until your supervisor comes back and are unable to contact him during a crisis. You have to make your own decisions in his absence and your action is dependent on the level of authority given.

The Big Picture:

It is not easy to handle a crisis if you are not aware of the all the facts. If your role is a leader, you have to be detached from the emotional side of the crisis and rationally take stock of how to move on. Again, this is not as easy as it sounds as you may have long-time colleagues who are involved in this crisis.

The Relevant Team:

It is important to be able to meet up with the relevant team to discuss about the situation. This is to ensure that the team is able to analyse and make a united stand about handling this crisis. This team should also comprise of the authorities, if the crisis is serious.

The Timeline:

You must construct a timeline and ensure that each process scenario is highlighted. This practice will be a check to prevent your team from spending too much time in one aspect of handling the crisis.

Procedural Manual:

Is there an organizational situational manual that you can use for this situation? Are you able to recollect the tips that were given to you when you participated in a mock drill?

External Experts:

You should get external experts to access the situation if the crisis is totally unanticipated. However, you must have had a close-door meeting with your inner circle. This is essential, as you do not want to unnecessarily reveal confidential information to external parties.

Speaking To The Media:

It is important to prepare a press kit-which provides a full detailed report about the crisis. If you are comfortable to conduct a press interview, you have to ensure that you have the full details first.

Your Communication Style:

You have to ensure that your communication style is in sync with the crisis. Remember to be forthcoming with reliable information and try not to speculate. This will also ensure that the victims' immediate families do not overly worry. It will also not help if you come across as very emotional in the media as you want to communicate that your organization has everything under control.

Beyond Your Control:

If the crisis involves the loss of lives, it is not unthinkable that your credibility and organisation's reputation is put into question. Assuming that the crisis was beyond your organisation's control, you have to stick to your best judgement and not be led into a debate that may open your organisation to possible legal action.

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