Original Article

A tale of two crises: Germany's *Landesbanken* and the United States' savings and loans

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ABSTRACT This research compares the experiences of financial institutions in two very different financial crises: savings and loan institutions (S&Ls) in the United States during the 1980s and Germany's state-owned banks, known as *Landesbanken*, during the global recession of 2007–2008. While much of the research on bank failures centers on the choices made by public and private actors according to their interests, this research focuses on the relationship between the ideas that drive an economic entity and the institutions that hold the economic entity accountable. The article argues that while the crises were very different, there is a causal thread that connects the two. *Landesbanken* and the S&Ls experienced a similar disruption in the complementarity between their original mission and their regulatory framework. The disruption contributed to increased volatility, weak oversight, and greater dependence on third parties and bank managers for risk information.

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INTRODUCTION

Best-selling autopsies[1] and award-winning films[2] present compelling accounts of how the actions of individuals and interests brought about the Great Recession. Recent popular accounts of the European debt crisis adopt a similar frame: citing the actions and choices of speculators, bankers, politicians and credit ratings agencies as causing the crisis.[3] While interest-based explanations direct public attention (and outrage) toward a problem, debates over how to regulate financial institutions are better understood as efforts to establish a regulatory framework (a system of organizations and rules) with the capacity to ensure that economic actors such as banks pursue a mission (an ideational goal) in line with the public interest. In other words, while the actions and poor choices of individuals may cause significant economic problems for economic actors, a systemic-wide financial crisis is triggered by disruptions to the complementarity between the economic actors' mission and the regulatory frameworks within which they operate. This article sheds theoretical and empirical light on the nature of that complementarity and the factors that disrupt it. This article tests the assertion that a disruption in the complementarity undermines financial stability through a comparative case study of two distinct financial crises: the near collapse of the US Savings and Loan industry during the 1980s; and the near collapse of Germany's system of state-owned banks, known as *Landesbanken*, during the global recession of 2007–2008.

A well-functioning financial system is characterized by a complementary relationship between the mission of economic actors and the regulatory framework within which they operate. 'Regulatory framework' refers here to a system of rules, organizations and privileges that maintain and reproduce values and norms about what actions are appropriate.[4] Lewellyn uses a similar term, 'regulatory regime', to describe how firms are held accountable through a combination of market discipline and internal governing structures.[5] And Hoffmann notes, 'a bank … is not a solitary actor; it exists and functions within a framework of institutions that together make it work as a depository intermediary'.[6] Mission refers here to the beliefs held by those in the organization about what the organization's purpose is. In the case of private firms, the mission is often to maximize profits or shareholder value. However, in public or public/private hybrid organizations, mission refers to what those in the organization believe to be the organization's *public* purpose.[7]

When a state creates an economic entity like a bank, the state also establishes the entity's mission and regulatory framework. As Susan Hoffmann's seminal work shows in the case of commercial banks, credit unions and savings and loans, the mission and regulatory framework are the result of a highly contested political process. However, once established, a complementary relationship develops between mission and its regulatory framework that creates a comparative advantage similar to the comparative institutional advantages described in the Varieties of Capitalism literature.[8] The comparative advantage fosters desirable policy outcomes that, in turn, reinforce and strengthen the complementarity and enable mission and framework to co-evolve.

Over time, however, the complementarity between mission and regulatory framework can be disrupted. The scholarly literature in comparative social welfare policy points to several potential sources for the disruption. Applying the work of Jacob Hacker, disruptions can occur as a result of 'drift', meaning the economic and social environment changes while neither the mission nor the regulatory framework adjust to the new context.[9] Drift may occur inadvertently or it may be the result of deliberate actions by individuals.

Disruption can also be triggered through the process of 'conversion', meaning the economic entity's purpose or mission is redirected toward a new purpose in order to pursue a different set of outcomes. Conversion can occur as a result of actions by policy makers or within the economic entity as it attempts to adapt to a new economic reality while still working within the original regulatory framework.[10] 'Layering' is another possible cause of disruption to complementarity, whereby policy makers and policy entrepreneurs add new mandates on top of an already existing set of purposes without adjusting the regulatory framework.[11] Whereas Hacker suggests disruptions can sometimes be inadvertent, Colin Crouch offers the possibility that the disruptions in complementarity are the product of intentional action by an institutional entrepreneur.[12] Policy scholars like John Kingdon make similar claims about the role of a policy entrepreneur seizing upon a crisis or triggering event to change a policy or prevent a change in policy.[13]

In the best case, the cost of disruption to the complementary relationship between mission and regulatory framework is a loss of the comparative advantage and a weakening in the economic entity's capacity to create favorable policy outputs. In the worst case, if the mission of the organization and the regulatory framework fail to co-evolve then we can expect an increase in volatility and risk leading to unintended and potentially costly outcomes.

In short, the puzzle at the center of debates over whether financial regulation should be left to governments or supra-national entities, is really about the ideational and institutional challenge of establishing (or re-establishing) complementarity between the mission of economic actors and the regulatory framework within which they operate. Equally important is knowing what factors might disrupt the complementary relationship.

The next section introduces the empirical cases. A side-by-side comparison of shifts in mission and regulatory framework is presented after that. Finally, the last section concludes and suggests implications for future research.

DIFFERENT CRISES, SIMILAR OUTCOMES

Disruptions in the complementarity between an economic actor's mission and the regulatory framework established to support the mission creates the condition for greater volatility and crisis. To test this claim empirically I employ a research design common in comparative politics known as a Most Different Systems Design. The strategy compares two very different cases that share a common outcome (or dependent variable). Given that the cases are different, if one can identify a causal factor they share in common then one can assume that the factor is the cause of the phenomenon.[14] Therefore I begin the empirical story with the claim that although both are banking crises, the experience of America's savings and loan institutions (S&Ls) and Germany's *Landesbanken* differ in important ways yet share a similar outcome. In the succeeding section I demonstrate how despite their differences, a disruption in the complementarity between mission and regulatory framework is a factor both cases share that explains their financial downfall.

S&Ls and *Landesbanken* are different types of institutions with contrasting origins, governing structures and purposes. S&Ls are depository institutions located throughout the country, designed in the 1930s to foster homeownership. Some S&Ls are governed as mutual savings banks where depositors and borrowers are given voting rights to select governing board members. Others are joint-stock companies controlled by private shareholders. German *Landesbanken* on the other hand are publicly owned institutions reconstituted after WWII to serve as the house banks for a state government.

The institutional setting also differs. S&Ls are embedded in a liberal-market economy characterized by a relatively underdeveloped institutional landscape, competitive markets and competitive inter-firm relations. *Landesbanken* are embedded in a coordinated-market economy characterized by a highly developed institutional landscape in which firms are closely connected by dense corporate networks of cross-shareholding, which enables banks (who are central stakeholders in those networks) to take a long-term patient view of lending.[15]

Finally, the timing and nature of the crises are different. The S&L crisis occurred in the 1980s and was largely limited to the United States. The recession of 2007/2008 began with the collapse of US housing market but quickly metastasized, bringing down financial institutions around the globe. But while the crises were different, they experienced similar outcomes.

Savings and loan crisis

Though their legacy stretches back to the Building and Loan Societies of the nineteenth century, modern day S&Ls were created out of the ashes of the Great Depression with the explicit social and public purpose of fostering and promoting home ownership. S&Ls were incredibly successful. During the five decades after they were established as part of the Federal Home Loan Bank Act of 1932, homeownership rates grew from 47.8 per cent 1932 to 64.4 per cent in the 1980s. S&Ls (also called 'thrifts') channeled the resources of large investors into home mortgages on standard terms that worked for moderate- and middle-income people. As Hoffmann notes, thrifts served their purpose effectively for 45 years.[16] By any account that is an extraordinary record for a policy. They financed the postwar housing boom and the suburban expansion and were crucial to the growth of newly developing parts of the country, particularly California. And the bank failures that brought the country to its knees during the Great Depression became a rare occurrence after WWII.

Interest rate spikes and an economic slowdown in the late 1970s and early 1980s created a rough environment for all financial institutions, including credit unions and commercial banks.[17] But the nature and severity of the S&L collapse put the industry's failure into a class all its own. From 1986 to 1995 the federal government was forced to close 1043 thrifts holding $519 billion in assets.[18] The industry went from being one of the most stable and successful banking systems in the history of the world to an industry with the tangible net worth of virtually zero by the early 1980s. Overall, nearly half the federally insured savings and loans in the United States disappeared (along with about a half a trillion dollars in asset value) in less than a decade, costing the US government $160 billion.

Nearly three decades after the thrift crisis, German state-owned banks known as *Landesbanken* also failed in spectacular fashion; part of the fallout of the global recession of 2007/2008. The history of German *Landesbanken* also stretches back well into the nineteenth century. *Landesbanken* along with *Sparkassen*, publicly owned local savings banks, comprise a third of Germany's three-pillar banking system.[19] The other pillars are private banks and cooperative banks. *Landesbanken* were reconstituted after WWII in each of the new states of the Federal Republic of Germany with the explicit social and public purpose of providing capital for state infrastructure projects, providing financing to firms and supporting locally owned savings banks. Like US thrifts, German *Landesbanken* proved to be remarkably successful and stable financial institutions that, for nearly a half a century, played a significant role financing Germany's economic miracle with relatively few failures. All that changed with the global recession of 2007/2008.

Although they comprised only approximately 21 per cent of all German banking assets before the crisis, Germany's *Landesbanken* accounted for 41 per cent of the losses during the Great Recession.[20] According to journalist Leo Müller *Landenbanken* purchased 500 billion euros worth of toxic assets.[21] Commercial banks like Deutsche Bank also suffered significant losses during the crisis. However, *Landesbanken* suffered the most severe combined losses. The *New York Times* reported that, '*Landesbanken* rescues – reminiscent of the financial crises at American-backed lenders Freddie Mac and Fannie Mae – have placed a serious burden on German state governments already suffering from slumping tax revenue, as well as the federal government, which is helping to cover some losses'.[22] Eight of the top 11 losses among German banks occurred in *Landesbanken*. *Landesbanken* losses were so large and severe that a report published by Germany's Federal Bureau of Statistics in 2008 called for privatization of all *Landesbanken*.[23] The consensus among German, OECD and IMF economists and public administration scholars is that while Germany's private banks made poor choices before the crisis, *Landesbanken* stand out as the major loss-makers.[24]

In short, the outcome of interest that I explain here is the reason for the failure of US thrifts and German *Landesbanken*. Their performance raises questions, the answers to which offer some insight into current debates around global financial regulation. Why, for example, was the financial toll of *Landesbanken* and S&Ls

so high and so sudden compared with other financial institutions? For example, it is not surprising that Germany's private banks, eager to maximize profits, jumped on the mortgage-backed securities bandwagon in the early and mid-2000s. But why would publicly owned institutions, with the distinctly social and public purposes of supporting regional economic development and infrastructure needs of German states, suddenly place highly leveraged bets on the Cleveland or Detroit housing markets? Similarly, the US banking crisis of the 1980s affected many financial institutions including commercial banks and credit unions. Yet, it was the thrift industry – whose business model for 40 years embodied stability and fiscal prudence – that collapsed under the weight of millions of risky investments, over a thousand failures and nearly a half billion dollars in losses.

DISRUPTION IN COMPLEMENTARITY AS A SHARED CAUSAL FACTOR

Despite their differences, the crises experienced by US thrifts during the 1980s and German *Landesbanken* during the 2000s shared a causal thread. In both cases the complementarity between mission and regulatory framework ruptured. After a long period of stability, the mission of thrifts and *Landesbanken* changed dramatically while the system of regulatory rules and organizations failed to adjust. To make this argument, I examine here the shift in mission and framework in *Landesbanken* and US thrifts.

Landesbanken mission and regulatory framework

Although public banks have been a part of the German financial landscape for more than 200 years, *Landesbanken* and their regulatory framework were reconstituted with the founding of the Federal Republic of Germany (West Germany) after 1945. At the close of the Second World War what had been 25 Central Banking Institutes serving the needs of *Sparkassen* were ultimately consolidated into 10 *Landesbanken* that matched up with the new federal structure of post-war Germany. Legally defined as an *Anstalt und Körperschaft des öffentlichen Rechts* ('corporations under public law'), German banking law directed *Landesbanken* and *Sparkassen* to foster and promote the public good.[25] In practice, this meant three things. It first meant the promotion of regional economic development. Managers and politicians believed that by channeling resources indirectly to small and mid-size firms, *Landesbanken* served a secondary aim of reducing inequality and allocating resources to areas that needed them most.[26] As the house banks for state governments, *Landesbankens'* second original mission was infrastructure development.[27] A final component was to support *Sparkassen* by clearing non-cash transfers, offering whole-sale lending, providing local institutions access to capital and refinancing.[28]

An element missing from the *Landesbanken* mission when reconstituted was profit maximization. Siekmann notes, 'A public corporation cannot have as its mission – as in the private sector – to achieve earnings or profits. Public corporations must always have as their goal the public good'.[29] In short the mission imprinted on the *Landesbanken* at their start was to pursue public goods while not adopting the private sector goal of profits and returns.

To ensure *Landesbanken* fulfilled their mission, the German state developed a regulatory framework that consisted of a set of rules/principles constraining the activities of the *Landesbanken,* and internal and external regulatory bodies. Two constitutional principles internalized within the *Landesbanken* governed where and how *Landesbanken* operated. The Regional Principle or *Ressortprinzip*[30] meant that *Landesbanken* limit their activity to a particular region or state. A second principle known as the Subsidiarity Principle or *Subsidiaritätsprinzip* governs how *Landesbanken* and *Sparkassen* divide up business within a region. The principle holds that human affairs are best handled at the lowest possible level, closest to those affected. In short, principles that limit how and where *Landesbanken* act were part of their DNA when they were reconstituted after WWII. Several regulatory bodies also played a central role in overseeing *Landesbanken*.

Germany's public and private corporations are governed by a two-tiered board system. A management board is responsible for operations while a supervisory board decides major personnel changes, weighs in on policies and ensures fulfillment of mission. Size and composition of the supervisory board is specified in state banking laws and varies across states. In general, *Landesbanken* include representatives selected by state governments, *Sparkassen,* and, in some cases, employees.[31]

While the size and composition of supervisory boards vary, scholars note that as economic entities charged with promoting a distinctly social and public good, elected officials and their appointees have the most influence in defining the *Landesbankens'* mission. A high-level manager who worked for the association representing *Sparkassen* for more than 20 years explained:

> You've got to understand one thing about how Supervisory Boards work: the politicians are first among equals. There may be experts, or representatives from employees and the *Sparkassen*. But ultimately everyone at the table knows that state governments get to write the rules and can change the rules if they want.(Interview, Sparkassen Association Manager).

The Banking Act of 1961 assigned the supervision of credit and financial services firms to two federal bodies: the independent central bank or *Bundesbank* and the Federal Banking Supervisory Office or *Bundesaufsichtsamt für das Kreditwesen* (BAKred), which served underneath the Federal Ministry of Finance. The central bank's primary mission was and remains to ensure price stability in Germany and secondarily, to promote a robust banking system.[32] The *Bundesbank's* supervisory role largely consisted of monitoring the system, collecting documents, reports, and annual accounts and ensuring that institutions were legally compliant. According to interviews with managers in the *Bundesbank* and the BAKred, the *Bundesbank's* approach to supervision was passive and had little impact on day-to-day behavior. A top regulator in the BAKred stated:

> Historically, the *Bundesbank* played next to no role in the supervision of *Landesbanken*. The Bundesbank's role in the past was mainly collecting data from the banks, maintaining databases, and then it analyzed the data in the aggregate. But in terms of actually supervising a bank: the Bundesbank played almost no role at all.

Reports published by the *Bundesbank* in the years following the Banking Act of 1961 support this view.

The BAKred (now BaFin) was the primary regulator of *Landesbanken* in Germany. The BAKred determined what supervisory measures, if any, were appropriate for a particular institution. The BAKred itself did not conduct audits, instead relying on the prudential risk profile prepared by the *Bundesbank*. Only in exceptional cases did the BAKred carry out audits of banking operations, either together with the Bundesbank or on its own.[33] According to executives within both entities, until the early 2000s, regulators thought that *Landesbanken* were not vulnerable. As one executive said:

> You have to take into account that until the 1990s, early 2000 – banks were considered to be indestructible especially the big banks … until the late 1990s early 2000s there was a very clear understanding that bank supervision … was a relatively simple process: ensure that institutions were in compliance with Germany's banking laws … . These were rules that stated a bank had to have x percentage of assets with capital. There were almost no rules governing risk management.

As *Landesbanken* were owned by state governments, regulators believed they would always be able to cover liabilities stating: 'if the

Landesbanken were really to run into problems their respective state government would rescue them – which is what happened during the recent crisis' (interview with BAKred Regulator).

The *Landesbanken* mission and regulatory framework were complementary. The regulatory framework placed most oversight with the supervisory board, which was composed of stakeholders with political appointees first among equals. This should have reduced principal-agent or moral hazard problems. Federal agencies play a tertiary oversight role. This functions because the social and public mission is to promote regional economic development, regional public infrastructure and support of local *Sparkassen*. The main controlling body contains experts and public officials from the region who understand the risks and benefits in lending to a firm, or building a new highway or school. *Landesbanken*'s rate of return was low compared to private banks. But the lending that *Landesbanken* did in the past often occurred precisely because these public banks accepted a lower rate of return to achieve other goals such as regional employment or improved health and safety.

Mission and regulatory framework in the early 2000s

As early as the late 1970s, academics expressed concern that Landesbanken were expanding their mission.[34] West LB, the *Landesbank* in North Rhine-Westphalia, is cited in interviews and scholarly accounts as the first to stray from its public mission. West LB's 1970s leader, Ludwig Poullain, sought to transform the *Landesbank* from a sleepy, provincial bank focused on regional economic development into a large global institution offering a range of universal banking services – including equity investments anywhere in the world.[35] Poullain was forced to resign in 1977 because of a financial scandal. Richard Deeg's study of West LB suggests 'conversion', to use Jacob Hacker's term; an intentional act by an institutional entrepreneur to redirect the mission of the *Landesbank*. Three years later, Frieder Neuber, took the helm and fulfilled Poullain's ambition by turning West LB into an international bank that competed with the largest private banks.[36] According to interviews with regulators and state bank officials, because it was the largest and most powerful *Landesbank* West LB influenced how other *Landesbanken* and other state governments understood their mission. Other state governments and *Landesbanken* incrementally followed suit – increasing their international activities, lending outside the region and enhancing their overall equity investment activity.

By the 2000s a consensus emerged that the mission of most *Landesbanken* had changed.[37] A 2008 report by a panel of experts on the German federal economy described the change:

> The business practices of the *Landesbanken* changed dramatically in the last few years … the *Landesbanken* shifted their business increasingly into corporate lending for financialization as well as into foreign financing and interbank business … the public purpose of the *Landesbanken* in the business models of most *Landesbanken* have disappeared.[38]

While significant anecdotal accounts show *Landesbanken* managers seeking to compete with private banks in maximizing returns, the main quantitative evidence given for the change in mission is the spike in the purchase of financial products in 2001.[39]

Until 2001 *Landesbanken* and their liabilities were guaranteed explicitly by state governments. The guarantees gave *Landesbanken* AAA credit ratings and lowered their borrowing costs by 15–20 basis points.[40] Private banks in Germany complained to the European Commission that *Landesbanken* had an unfair advantage.[41] The Commission's position was that member states are free to use public assets to achieve policy objectives but not to support commercial activities. The Commission ruled that because of the *Landesbankens'* extensive commercial involvement, the state guarantees violated EU law. The Commission gave the *Landesbanken* a 4-year transition period so that until 31 December 2005 Landesbanken could borrow with government guarantees at a maximum duration through 2015. The decision by the EU did not cause the Landesbanken to shift their mission. However, the decision accelerated the shift.

Rather than view the EU decision as cause to scale back on their private missions, the *Landesbanken* took the decision as a deadline to accrue as much 'cheap' capital as they could.[42] The volume of funds raised on international capital markets after 2001 far exceeded domestic demand. *Landesbanken* used the excess capital to invest internationally, including in mortgage-backed securities. Between February 2002 and July 2005 the outstanding stock of bonds with government guarantee rose by about 25 per cent while other banks' outstanding bonds fell.[43] *Landesbanken* used these funds to invest abroad. The assets in foreign securities more than doubled between mid-2005 and mid-2008. Even as private banks reduced their holdings of foreign assets in mid-2007, *Landesbanken* increased their holdings until well into 2008.[44]

By the early 2000s *Landesbanken*'s conversion was complete. They had strayed far from the original mission in at least three ways. First, investments were no longer regionally confined. Instead *Landesbanken* were doing business worldwide including London, Dublin and New York. Second, the business model centered more on trading of and exposure to risk, that is, financialization. Finally, the *Landesbankens'* three original missions – regional economic development, infrastructure and support of savings banks – had declined in importance relative to risky profit-taking investments abroad.[45] The audit by the state of Saxony's LB Auditor General's office noted that state legislators passed several laws in the late 1990s that facilitated Landesbank investment in derivative and structural financial vehicles. The Auditor noted:

> The close relationship between the business of Sachsen LB and its public mission, tethering the banks' business primarily to the public goals of promoting Saxony's economy through credit – all this was given up. The Sachsen LB was and did whatever it wanted in order to serve the interests of the bank.[46]

In short, the mission adopted by *Landesbanken* in the early 2000s had more in common with private credit institutions than locally owned public banks. Had the regulatory framework co-evolved along with the new mission, it is possible that the disruption of the complementarity between mission and regulatory framework could have been avoided. Unfortunately, the original regulatory framework largely remained in place even as *Landesbanken* had shifted. Historic-based structures of oversight and accountability had changed little even as the *Landesbanken* shed their social and public purpose for a more private- and profit-oriented mission.

Interviews with regulators and public bank managers suggest that even as state guarantees were eliminated, the regulatory framework changed little during this period. Regional and subsidiarity principles remained in place but were often ignored by *Landesbanken* and supervisory boards. The structure and composition of the supervisory boards of *Landesbanken* also remained intact during this period. Hau and Thum's analysis underscores how little was done before 2006 to change the composition of the supervisory boards, which remained dominated by political appointees.[47] Interviews with regulators and former *Landesbanken* managers, as well as, audits of failed *Landesbanken,* suggest state officials began to see *Landesbanken* as revenue generators for state budgets; enabling states to plug budgetary holes without spending cuts or tax increases.

Interestingly, the two external regulatory bodies – *Bundesbank* and BAKred – changed in the 2000s but for reasons unrelated to shifts in *Landesbanken* mission. Passed in 2004, Basel II created risk and capital management requirements designed to ensure that banks have adequate capital for risk created by lending and investment practices. Basel II not only imposed higher capital requirements, but it also required federal regulators to assess banks' credit, lending and investment risks. In response to Basel II, the Bundesbank changed its approach from one that relied on banks and auditors for risk information to one that required the *Bundesbank* to assess independently and more quantitatively the level of risk. Bundesbank regulators note that this was a significant change in what the Bundesbank did and how. Both federal regulatory agencies needed several years to build up the capacity – the expertise and personnel – to implement the Basel II rules. Thus, at the very moment *Landesbanken* embraced their new return-maximizing mission, federal regulators' approach to risk assessment looked a lot like it had for 40 years.

The second change in the regulatory framework occurred with the BAKred. In 2002 the coalition government of the Social Democrats and Greens, led by Gerhard Schroeder, merged the BAKred with the supervisory agencies overseeing insurance and securities markets. The new organization, modeled on the British Financial Service Authority, became the Federal Financial Supervisory Authority (*Bundesanstalt fuer Finanzdienstleistunsaufsicht* or BaFin). Again, the change in the framework was not prompted by the new mission of the Landesbanken. Instead, the restructuring was about efficiency and moving Germany closer to a European-wide system of regulation.[48] Political leaders like Finance Minister Hans Eichel argued that by combining the supervisory responsibilities for banks, stock exchanges and insurance under a single financial supervisor, the new agency could reap the benefits of synergy.

According to those within the newly created BaFin, the agency took several years to develop. Merging three separate organizations generated its own set of bureaucratic problems and meant that at the time when *Landesbanken* would have benefited from more rigorous oversight, they actually received less because of organizational changes that imposed adjustment periods on regulators.

The bottom line is that despite Basel II and significant structural changes, relatively little changed in terms of regulatory capacity in the early 2000s. Indeed, several interviewees noted that demands brought about by Basel II and the creation of BaFin reduced federal regulatory capacity in the early 2000s as federal agencies came to terms with new roles and structures.

US thrifts' mission and regulatory framework

The legacy of US thrifts also stretches back to the nineteenth century and the early Building and Loan Societies. However, modern day S&Ls' mission and regulatory framework were established in the early 1930s.[49] Like *Landesbanken,* US thrifts were established to pursue a specific *public* purpose: to promote and foster homeownership among people of modest means through suitably structured financing.[50] As Hoffmann notes, 'The savings and loan framework was built for the particular public purpose of promoting home ownership in the United States, which was not well served by banks'.[51] Though home ownership was a deeply ingrained cultural value, its support and preservation was not an object of national policy. As Secretary of Commerce (1921–1928), Herbert Hoover had established a Division of Building and Housing to foster home ownership because of concern that 'the sentiment, "Own your own home", was losing force'. Hoover understood that a major obstacle to homeownership was housing finance.

How so? In 1931 the typical 'straight' first mortgage loan was for 40–60 per cent of the appraised value of a house. Its term was likely to be 1–5 years, during which time only interest was paid. At the loan's expiration, the principal was due in full. Financing of this kind was problematic before the Depression. With the depression, mainstream housing finance collapsed. Borrowers struggled to make payments and, more importantly, lenders were unwilling and unable to refinance the loans, resulting in millions losing their homes. Hoover came up with an elegant solution.

In late 1931 Hoover asked Congress for legislation that established the Federal Home Loan Bank System (FHLB System) as a source of liquidity and low-cost financing for S&Ls.[52] Hoover's concept was to create 12 regional Home Loan Banks throughout the country that would loan money to S&Ls on the collateral of their home mortgages. Further, the Banks would be set up as cooperatives. All 12 would share joint liability for their bonds and the member-thrift in each of the regions would share ownership of their FHLBank through stock purchases.

Congress responded by passing the Federal Home Loan Bank Act (FHLBank Act) in July 1932, which reformed the country's financial structure in the service of homeownership by (1) directing building and loan associations (which become S&Ls) to make home ownership feasible to purchasers; and (2) creating new institutional channels that facilitated the flow of society's financial resources into home ownership. The Home Owners' Loan Corporation Act (HOLC) passed in 1933, a year after the FHLBank Act, further codified the S&Ls mission: thrifts could earn a modest return in order to exist but their primary mission at their birth was strictly to foster home ownership.

As with *Landesbanken*, a regulatory framework was established to ensure thrifts stayed on mission and remained accountable. In addition to creating the FHLBank System, the FHLBank Act established a new regulatory entity known Federal Home Loan Bank Board (FHLBB) located in Washington DC. A year later, Section 5 of the HOLC Act of 1933 authorized the FHLBB 'to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations"'. The FHLBB was thus given authority to oversee and regulate thrifts. But the structure of oversight was unusual.

From the outset the FHLBB was both regulator and promoter of the thrift industry. The HOLC Act authorized the FHLBB to charter, regulate and supervise thrifts in a manner similar to the Office of the Comptroller of the Currency (OCC) to national banks. But, unlike the OCC, the FHLBB understood that its job was to help the thrift industry expand[53] and adhere to rules and regulations. As Strunk and Case note, the FHLBB understood itself to be an advocate for the thrift business and to see to it that credit flowed from the FHLBanks to thrifts in 'unlimited quantities, and at reasonable prices'.[54] At the same time, the FHLBB 'were not … patsies of the business … [the FHLBB] sought to keep the thrift business from making mistakes and confined [them] to making sound home mortgage loans'.[54] The FHLBB thus had from the outset a dual mission of regulation and promotion, creating a potential conflict common to other agencies such as the Federal Aviation Administration.

The system of organizations charged with regulating S&Ls share some similarities with the German case. As with *Landesbanken*, examination and supervision of the thrift industry were divided into separate organizations with different governing boards and structures. S&L examiners were hired by and reported to the Office of Examination and Supervision of the FHLBB in Washington DC. FHLBB examiners were purely fact finders with little discretion. Unlike commercial bank examiners, thrift examiners were not asked to judge the value of an association's assets or even given the authority to require certain reserves against assets. Moreover, the size of examiners' staff and budget remained low even as the thrift industry grew in size and complexity. Strunk and Case note that from the 1930s through end of the 1970s, 'the examination process dealt with little beyond regulatory compliance … examiners were to be purely fact finders and that the "do's and don'ts" were expressed in regulations … examiners were not trained or experienced in financial analysis'.[55] At the same time examiners embraced a passive regulatory philosophy, supervisory authority was assigned elsewhere.

The FHLBB designated each regional FHLBank president as the Principal Supervisory Agent (PSA) for that region. Senior bank staff at each of the 12 FHLBanks were made the supervisory agents for the system and reported to the president of each regional Bank. And just as the Bundesbank supplied the BAKred with information about *Landesbanken*, the FHLBB examiners provided facts to the FHLBank supervisors. In contrast to examiners, supervisory agents had the discretion to act on the information provided by examiners. It was a complex system of oversight with multiple potential conflicts of interest. As a Federal Deposit Insurance Corporation (FDIC) report noted, 'in contrast to the banking agencies, no agency had a single, direct line of responsibility'. Moreover, as they were owned by the institutions they supervised, FHLBanks operated like 'independent duchies'.[56]

The final organizational component to the S&L framework was depository insurance. A year after the creation of the FDIC, which insured bank deposits, Congress passed the National Housing Act of 1934 that established the Federal Savings and Loan Insurance Corporation (FSLIC). FSLIC's main purpose was to ensure the flow of funds in S&Ls for home ownership. FSLIC levied an annual insurance premium of one-fourth of 1 per cent of total deposits. At the outset FSLIC was designed to cover all insured deposits but it lacked a rule specifying how the deposits would be covered during a crisis. Thus, as all insured depositors are protected, the government essentially guaranteed all thrifts against insolvency. In this sense, thrifts enjoyed a guarantee similar to the state guarantees enjoyed by *Landesbanken* before the European Commission's ruling in 2001. Finally, FSLIC was not independent like the FDIC. Instead, the Housing Act established FSLIC as an arm of the FHLBB. Therefore, for commercial banks and mutual savings banks, the regulation and insurance functions were kept separate, whereas for S&Ls the two functions were housed within the same agency.

Given the complex regulatory framework it is remarkable that thrifts were not only successful in their public and social mission but they were also relatively free of oversight problems for nearly five decades. The primary reason is that the business activity of US thrifts was limited by a number of regulations. First, thrift activity was limited to financing conventional home mortgages. They were not allowed to make commercial, agricultural or multi-family loans. And, as noted above, only conventional home mortgages could be pledged as collateral toward FHLBank loans.

The HOLC Act also limited federal S&L lending to within 50 miles of its main office and to homes appraised at 20 000 dollars or less. The statute eliminated the various stock ownership options permitted in some states. The newly established federal S&Ls were all mutual associations. They could not be owned by a few people primarily interested in profit or financing their own speculative real estate activity.[57]

While thrifts were limited in what they could do, Congress also gave thrifts financial help to promote home ownership. Until the 1980s the savings interest rates at all depository institutions were capped. But S&Ls were allowed by federal statute to pay as much as 200 basis points more than the interest rate cap commercial banks faced. In 1966, when Regulation Q[58] was extended to thrifts, S&Ls were permitted to pay 25–50 basis points higher than commercial banks. The view was that with marginally higher savings rates, savings and loans would attract more deposits that would allow them to continue to write more mortgage loans, which would keep the mortgage market liquid, and funds would always be available to potential borrowers. In short, the business model under which thrifts operated was straightforward and boring. For more than four decades it conformed to the '3–6–3' myth: they borrowed money at 3 per cent, lent at 6 per cent and were on the golf course by 3.

With the benefit of hindsight and the recent experience of the global recession, the conflicts-of-interest problems in the S&L's initial regulatory framework stand out. However, at their creation and through most of their history, the regulatory framework worked because it complemented the mission of thrifts. So long as thrifts continued to limit their business to conventional home mortgage lending there was little need for examinations beyond regulatory compliance. The fact that regional FHLBanks had supervisory authority made sense as FHLBanks had the regional experience to understand the lending decision of thrifts in their district. And equally important, FHLBanks had a strong financial stake, through their lending to thrifts, in ensuring that thrifts stayed the '3–6–3' course.

The FHLBB's dual role of regulator and promoter of thrifts also complemented the thrift's original mission. The FHLBB aggressively pushed to give new charters to more and more thrifts in order to provide the capital for the post-war housing boom. As Strunk and Case note, 'The system worked satisfactorily, or so it appeared. The business was relatively simple, and given the highly regulated environment not many associations got into trouble quickly. The system proved completely inadequate, however, in the 1980s.[59]

THRIFTS' MISSION SHIFT AND THE REGULATORY FRAMEWORK IN THE EARLY 1980S

Although Congress and the FHLBB initiated a number of changes to the S&L industry throughout the post-war period, the mission of thrifts remained focused on home ownership until the 1970s and early 1980s.[60] Their primary product was the conventional long-term fixed home mortgage. In the 1970s the mission of thrifts took a dramatic turn that reflected Hacker's concept of conversion – thrifts were compelled to adapt to a new economic reality in order to survive.

Fluctuation in short-term interest rates was a big problem for thrifts as early as the 1960s. Interest rate ceilings prevented S&Ls from paying competitive interest rates on deposits. Thus, every time the market interest rates rose, substantial funds were withdrawn by consumers for placement in instruments with higher rates of return. At the same time, there was growing competition from money market funds. And because S&Ls were prohibited from any business other than accepting deposits and granting home mortgage loans, it made it particularly difficult to stem the tide of disintermediation. The problem became acute in the late 1970s when interest rates spiked. Thrifts responded by lobbying Congress aggressively to change rules to allow them to compete with banks and money market funds; to, in effect, change their mission.

Congress and the administration responded to the call for help from thrifts by passing the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn St Germain Depository Institutions Act of 1982 (Garn St Germain). The two laws dramatically expanded thrifts' investment powers and eliminated deposit interest-rate ceilings. The laws expanded the authority of federally chartered thrifts to make acquisition, development and construction loans. They eliminated the previous statutory limit on loan-to-value ratios. They increased federal deposit insurance from \$40 000 to \$100 000 per account. The federal changes prompted states to enact even more liberal regulatory changes to state-chartered thrifts in a race-to-the-bottom.[61]

The FHLBB also took a number of regulatory actions to attract capital to the industry.[62] The most dramatic regulatory change was in ownership restrictions. Traditionally, federal chartered stock associations were required to have a minimum of 400 stockholders, 75 per cent of whom had to reside or do business in the thrift area. The elimination of these restrictions, coupled with the relaxed capital requirements, invited new owners into the industry and allow the new owners to operate with a high leverage ratio and generate extraordinary returns on capital.

Just as the EU directives impacted the mission of *Landesbanken*, the legislative and regulatory changes encouraged thrifts to convert their traditional public purpose for a private profit-maximizing mission. And like the *Landesbanken*, thrifts embraced their new freedom.

Between 1980 and 1985 S&Ls grew dramatically. Total assets held by FSLIC-insured S&Ls

increased 60 per cent from $604 billion to $1068 billion. And, even as a number of S&Ls were becoming insolvent, the industry added close to 500 new thrift charters. The expansion was made possible by the influx of deposits that were attracted to the uncapped deposit rates. The shift in mission was most evident in the assets held by thrifts. In 1981, 78 per cent of thrifts assets were mortgage loans. Five years later the percentage had dropped to 56 per cent.[63] Thrifts could now invest in real estate, equity securities, service corporations and operating subsidiaries without limitations. In 1983 and 1984 more than $120 billion in net new money flowed into thrifts, attracting risk-takers and transforming industry mission. And, as Richard Posner notes, the increase in depository insurance during this time only exacerbated the moral hazard problem.[64] William Seidman, chairman of the FDIC during and after the crisis, wrote, ‘A deposit insurance system is like a nuclear power plant. If you build it without safety precautions, you know it’s going to blow you off the face of the Earth. And even if you do, you can’t be sure it won’t’.[65] Had the regulatory framework co-evolved alongside the new mission, it is possible that the disruption of the complementarity could have been avoided. Unfortunately, regulation and oversight did not evolve.

As the new mission took hold, the system of regulatory organizations, established in the 1930s, remained largely in place. The separation of banking examiners from supervisors remained in place. There continued to be significant delays between audits by examiners and actions by supervisors. Even as hundreds of S&Ls were falling into insolvency and the industry as a whole had a net worth approximating zero, there were very few enforcement actions taken before 1985. The FHLBB continued to be in charge of regulating, chartering and promoting thrifts as it always had. But as the industry was struggling with competition and high interest rates, the Bank Board focused attention more on promoting the industry than on regulating it. Perhaps most surprising is that the deposit insurance system established in the HOLC Act in 1933 failed to change even as the risk in the system and the amounts insured increased dramatically. Congress and the FHLBB continued to insist, as it had throughout the post-war period, that deposit insurance premiums be based on an institution’s domestic deposit accounts not its level of risk. That system remained in place even as thrifts were investing in everything from wind farms to the Dallas Cowboys football team.

Efforts to adjust the regulatory framework were met with resistance. Initiatives within and outside the FHLBB increased audits of thrifts, gave examiners great authority to audit the safety and soundness of associations, and increased the number of supervisory actions. But such efforts were met with fierce resistance within the administration and the industry itself. Like *Landesbanken*, at the very moment when thrifts needed to adjust their regulatory framework the most, the forces opposed to change were strongest. The growth of the industry during the early 1980s meant that interest groups like the US League of Savings Institutions were at their most powerful and aggressively resisted efforts to change the oversight structure. As a result, when FHLBB president Edwin Gray asked the Reagan administration to double the number of examiners and increase their pay, Connie Horner, assistant to the Director of OMB told him the administration wanted fewer regulators, not more.[66] In short, before the 1980s, thrifts had limited powers and few failures, and the FHLBB was a small agency overseeing an industry that performed a public service. As Benston and Kaufman note, FHLBB, FSLIC and the FHLBank System were geared to deal with an earlier era, ‘The sudden increases in allowable activities and risk taking found them greatly understaffed, undertrained, and underorganized; thrift supervision was grossly inadequate’.[67]

CONCLUSION

At first glance, the experience of US S&Ls and German *Landesbanken* looks like notorious examples of self-interest, greed and bad decisions by both private and public actors. After decades of stability, *Landesbanken* responded to the EU Commission's decision in 2001 that ended state guarantees by exploiting a 4-year window and building up a giant pool of money: borrowing heavily on international capital markets and investing the cheap money in seemingly safe housing investments with attractive returns. US thrifts responded to legislative and regulatory changes in the 1980s by borrowing record sums, and then also investing their giant pool of money in risky and unfamiliar ways. The benefit of hindsight makes it easy to see that these were extremely poor decisions that cost taxpayers billions. However, this research finds that poor management decisions are only part of the story, albeit an important one.

S&Ls and *Landesbanken* followed what Jacob Hacker describes as policy conversion. Beginning in the 1960s and 1970s the largest *Landesbank*, West LB, began to convert to a new mission as a result of actions taken by the bank's leadership. Later, however, the mission of nearly all *Landesbanken* shifted in order to adapt to a new economic reality, one characterized by greater domestic and global competition. They shifted their missions partly in response to a new economic reality. Savings and Loans also converted to a new mission beginning in the 1970s in response to shifts in the domestic economy. It is unlikely that either would have survived had they not changed. But when their mission shifted, much of their regulatory framework remained stable and failed to adjust. It is that inability to co-evolve that disrupted the long-term complementarity between mission and regulatory framework. Although the mission of both economic entities shifted fairly quickly, the regulatory framework remained largely intact.

One question is why the regulatory frameworks in both cases did not adjust even as the missions were shifting. One answer lies in Paul Pierson's concept of path dependency: political and societal interests, who had benefited from the status quo, blocked efforts to adjust the regulatory framework even when adjustments were clearly necessary.[68] In Germany, state government officials who controlled the supervisory boards were reluctant to cede authority or alter the regulatory framework even as their institutions were investing in products they had never seen before and did not understand. Similarly, in the United States, lobby organizations for the S&L industry effectively resisted efforts to change the regulatory structure even as it was clear that many thrift institutions were engaged in highly risky activities.

There is also support for public administration theories of organization. Even if policy makers in both countries had wanted to adjust the regulatory framework quickly it would have been difficult. Changing large complex systems of organizations is like changing the course of large oil tanker in a storm: it is difficult, risky, and generally very slow.

The impact of the disruption in the complementarity between mission from regulatory framework was profound and contributed to three outcomes. First, it reduced the capacity of regulatory actors to effectively assess the new risks. In the case of *Landesbanken*, for example, supervisory board members and regulators relied on management and third parties for information about riskiness of investments. Similarly, thrift examiners were also made far more dependent on the thrift managers for information about the riskiness of assets.

In addition to being more dependent on management, decoupling ideas from the regulatory framework meant that at the very moment when *Landesbanken* and S&Ls required the greatest oversight, the regulatory framework was least able to provide it. Finally, decoupling ideas from institutions led to enormous variability in the performance of *Landesbanken* and S&Ls. *Landesbanken* and US thrifts had historically had stable rates of return that fluctuated less than returns in private banks. Disruption generated significantly variability, however. Rates of returns spiked in both cases and then, of course, returns plummeted.

In sum, the experience of *Landesbanken* and S&Ls is both tragic and informative. The economic institutions upon which Germany established itself as a thriving post-war capitalist democracy are now targets of privatization and consolidation.[69] In the United States, Savings and Loans are thriving but their structure and purpose make them nearly indistinguishable from other charters. *Landesbanken* and S&Ls illustrate the importance of institutions and ideas. In both cases their public mission became less important than private goals. The regulatory framework, however, failed to adjust to the changing reality. Why? Because, regulatory frameworks once created are difficult to change. It takes time, energy, resources and significant political will to adjust. The lesson is that while it is relatively easy to encourage an economic actor to behave differently, we ignore the institutional context at our peril.

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