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052182754X - From Building and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831–1995

David L. Mason

Excerpt

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## INTRODUCTION

In his movie *It's a Wonderful Life* the director Frank Capra tells the story of George Bailey, the manager of the Bailey Bros. Building and Loan. This thrift association is in Bedford Falls, a small community where people know each other, families are stable, and personal morals are strong. Although the town also has a bank, most of the working-class residents belong to the local building and loan. A turning point in George's life comes on Christmas Eve when an audit reveals that \$5,000 is missing from the thrift. George is unable to account for the funds, and after the banker Henry Potter accuses him of stealing the money, George panics and considers suicide. To prevent this, George's guardian angel Clarence lets him see what life in Bedford Falls would be like if he were never born, and by extension if his thrift did not exist. In a world without George and his building and loan, Potter controls the town and dominates the lives of its residents. Called Pottersville, the town is no longer peaceful and happy but a place where drinking, vice, and debauchery reign supreme. Most of the people rent apartments from Potter, have dysfunctional families, and generally regard each other warily. The experience makes George realize how important he and his work are to the community, which causes him to keep on living and face arrest for malfeasance. In the end, the people of Bedford Falls rally to support George with donations that not only cover the missing funds but also lead the authorities to drop the criminal charges against him.<sup>1</sup>

<sup>1</sup> One journalist described this as the nation's "first S&L bail out." Kathleen Day, *S & L Hell: The People and the Politics Behind the \$1 Trillion Savings & Loan Scandal* (New York: W. W. Norton & Co., 1993), 38; *It's A Wonderful Life* (Metro-Goldwyn-Mayer, 1946); Vito Zagarrio, "It Is (Not) a Wonderful Life: For a Counter-reading of Frank Capra," in Robert Sklar and Vito Zagarrio, editors, *Frank Capra: Authorship and the Studio System* (Philadelphia: Temple University Press, 1998), 64–94; James Agee, *Agee on Film* (New York: Grosset & Dunlap, 1969), 233–4; Ray Carney, *American Vision: The Films of Frank Capra* (New York: Cambridge University Press, 1986), 379, 381–2; "It's a Wonderful Life," *Savings and Loan News* 67 (February 1947), 17.

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In this cinematic masterpiece, Capra's main objective was to "encourage audiences to recognize the heroism involved in merely living a helpful but ordinary life." However, Capra also provided an accurate sketch of America's thrift industry during its heyday of the late 1940s and early 1950s. An examination of the movie from the perspective of the Bailey Bros. Building and Loan reveals that the primary goal of a thrift was to help working-class men and women become homeowners. By following the basic principles of systematic savings and mutual cooperation, thrift members could borrow money to buy their homes. The movie also revealed the widespread assumption of Americans that private homes provided the best environment for raising a family, and that pride of owning a home generated higher personal self-esteem and good citizenship. Finally, because the building and loan was such an integral part of Bedford Falls, when events threatened to close this thrift, the town fought to save it.<sup>2</sup>

Although Capra apparently never intended *It's a Wonderful Life* to be an homage to the savings and loan industry, he nonetheless provided a useful snapshot of a business that, to date, has not received much scholarly examination. This is not to say that historians have ignored the study of finance in America, as evidenced by many valuable histories of investment and commercial banking.<sup>3</sup> One reason for the growing number of works on these industries is that each was critical in financing big business and making America an economic superpower. Similarly, historians have closely examined the relationship between business and government, especially those actions that helped the federal government assume greater economic and social responsibilities in the twentieth century.<sup>4</sup> Finally, while scholars have explored the role financial intermediaries played in the growth of American cities and suburbs, the majority of works in this area focus on federal government activities and not on those of savings and loans.<sup>5</sup> Because my project

<sup>2</sup> Wes D. Gehring, *Populism and the Capra Legacy* (Westport, CT: Greenwood Press, 1995), quote 112.

<sup>3</sup> For representative histories, see Vincent P. Carosso, *Investment Banking in America, a History* (Cambridge, MA: Harvard University Press, 1970); Benjamin J. Klebaner, *American Commercial Banking: A History* (Boston: Twayne Publishers, 1990); Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Atlantic Monthly Press, 1990); William F. Hixson, *Triumph of the Bankers: Money and Banking in the Eighteenth and Nineteenth Centuries* (Westport, CN: Praeger, 1993); Edwin J. Perkins, *Wall Street to Main Street: Charles Merrill and Middle-Class Investors* (New York: Cambridge University Press, 1999).

<sup>4</sup> Seminal works include Thomas K. McCraw, *Prophets of Regulation: Charles Francis Adams, Louis D. Brandeis, James M. Landis, Alfred E. Kahn* (Cambridge, MA: Belknap Press of Harvard University Press, 1984); Thomas K. McCraw, editor, *Regulation in Perspective: Historical Essays* (Cambridge, MA: Harvard University Press, 1981); Richard H. K. Vietor, *Contrived Competition: Regulation and Deregulation in America* (Cambridge, MA: Belknap Press of Harvard University Press, 1994).

<sup>5</sup> See Sam Bass Warner, *Streetcar Suburbs: The Process of Growth in Boston, 1870–1900* (Cambridge, MA: Harvard University Press, 1978); Kenneth T. Jackson, *Crabgrass Frontier:*

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combines elements from all three areas into one study, it fills the scholarly gap in the literature on S&Ls, and helps define their overall role in American business history.

At the end of the twentieth century, America's 1,103 thrift institutions controlled more than \$863 billion (in US billion) in assets, equivalent to about 8 percent of the nation's gross domestic product in 1999. Thrifts continue to serve as a significant source of residential home mortgages and are the second-largest repositories for consumer savings in the country.<sup>6</sup> Despite their critical importance to the financial structure of the United States, thrifts have been grossly neglected by scholars. Only five extensive histories of this industry are available. All were written by industry insiders, and none cover the events of the S&L crisis.<sup>7</sup> Conversely, books and articles on the financial debacle of the 1980s abound. Unfortunately, many are journalistic accounts that focus on the criminal misconduct associated with individual thrift failures. Furthermore, only a handful of these works place the events of the decade in any historic perspective.<sup>8</sup>

This study attempts to correct these deficiencies in three ways. First, by examining the entire history of the American savings and loan industry, I

*The Suburbanization of the United States* (New York: Oxford University Press, 1985); Robert Fishman, *Bourgeois Utopias* (New York: Basic Books, 1987).

<sup>6</sup> Office of Thrift Supervision. 2002 *Fact Book: A Statistical Profile on the United States Thrift Industry* (Washington, DC: Office of Thrift Supervision, April 2003), 1, 4.

<sup>7</sup> H. Morton Bodfish, *History of Building and Loan in the United States* (Chicago: United States Building and Loan League, 1931); Horace Russell, *Savings and Loan Associations* (Albany: M. Bender, 1960); Josephine Hedges Ewalt, *A Business Reborn: The Savings and Loan Story, 1930–1960* (Chicago: American Savings and Loan Institute Press, 1962); Leon T. Kendall, *The Savings and Loan Business: Its Purposes, Functions, and Economic Justification* (Englewood Cliffs, NJ: Prentice-Hall, 1962); A. D. Theobald, *Forty-Five Years on the Up Escalator* (privately published, 1979). Bodfish wrote his history to celebrate the centennial of the industry, and it was distributed at the annual convention of the thrift trade association. Russell's work is primarily a memoir of the author's career at the Federal Home Loan Bank Board, while Ewalt wrote her book while serving as the chief publicist of the thrift trade association. Kendall was the chief economist for the United States Savings and Loan League and wrote his monograph for the Commission on Money and Credit. Theobald's book is the only detailed history of the thrift industry between 1930 and 1979.

<sup>8</sup> Representative books include Paul Zane Pilzer, *Other People's Money: The Inside Story of the S&L Mess* (New York: Simon and Schuster, 1989); Stephen Puzo, Mary Fricker, and Paul Muolo, *Inside Job: The Looting of America's Savings and Loans* (New York: McGraw-Hill, 1989); James O'Shea, *The Daisy Chain: How Borrowed Billions Sank a Texas S&L* (New York: Pocket Books, 1991). Among the few books that include a basic history of the thrift industry are James Ring Adams, *The Big Fix: Inside the S&L Scandal* (New York: John Wiley & Sons, 1989); Kathleen Day, *S&L Hell: The People and Politics Behind the \$1 Trillion Savings and Loan Scandal* (New York: W. W. Norton, 1993); Ned Eichler, *The Thrift Debacle* (Berkeley: University of California Press, 1989); James Barth, *The Great Savings and Loan Debacle* (Washington, DC: AEI Press, 1991); Mark Carl Rom, *Public Spirit in the Thrift Tragedy* (Pittsburgh: University of Pittsburgh Press, 1996); Kitty Calavita, Henry N. Pontell, and Robert H. Tillman, *Big Money Crime: Fraud and Politics in the Savings and Loan Crisis* (Berkeley: University of California Press, 1997).

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not only place the recent past in a broad context, but also offer new insights into the development of consumer finance. Second, my extensive use of industry sources provides a different perspective about how and why S&Ls responded to the array of different economic conditions and crises that they faced over the years. Finally, by accessing previously untapped government archival documents I enhance our understanding of the relationship between the industry and federal regulators.

Given this multifaceted approach, my work should interest scholars in a variety of fields. For economic and business historians, this study strengthens our understanding of how American finance developed over time; in particular the role small enterprises play in meeting the financial needs of consumers. It also contributes to the literature on government-business relations and thus will be of interest to scholars of political science. Similarly, scholars focusing on “household” finance will find this work a valuable resource on the development of various types of lending, such as installment and mortgage loans. Meanwhile, business professionals will learn more about how financial firms evolve over time. Finally, academics focused on African American, ethnic American, and women’s studies will find new information that expands and breaks new ground in understanding the relationship between these groups and American business.

Although a chronological history, this study is organized around four broad themes. The first focuses on the evolution of saving and loans business practices. Thrifts began as a way for working-class men and women to obtain affordable long-term home mortgages and simultaneously have access to a safe repository for savings. They were typically nonprofit cooperatives, which were owned by their members and often relied on word-of-mouth advertising to attract business. As neighborhood businesses, civic leaders usually served in top leadership positions, and the close ties these managers maintained with the local community allowed thrift members to better monitor the association’s lending activities. Finally, thrifts employed a variety of legal structures and lending procedures that were tailor-made to meet member needs. While such eclectic practices often served members well and met local financial needs, they also made thrifts appear to be less prestigious than commercial banks.<sup>9</sup>

The thrift industry remained a small but important source of consumer finance for the first one hundred years of its existence, and although S&Ls used more uniform practices, they remained member-owned institutions. This changed after World War II when the postwar housing boom produced

<sup>9</sup> For a discussion of the role of agency in business and finance see Jonathan Barron Baskin and Paul J. Miranti, Jr., *A History of Corporate Finance* (New York: Cambridge University Press, 1999), 20–24 and Jonathan Barron Baskin, “The Development of Corporate Financial Markets in Britain and the United States, 1600–1914: Overcoming Asymmetric Information,” *Business History Review* 62 (Summer 1988), 199–237.

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an unprecedented demand for mortgages. To meet this demand, the industry developed innovative business procedures, and some thrifts even began to raise funds by selling stock on the open market. The growth that resulted from this period significantly enhanced the image of thrifts as financial institutions, and gave the industry greater political and business clout. It also, however, caused the industry to become divided into a handful of large institutions capable of competing directly with commercial banks and thousands of smaller, more traditional, associations. Although competition between thrifts and banks for funds was especially high during the 1960s, in terms of lending S&Ls continued to be undiversified, with mortgages accounting for more than 80 percent of industry assets. Because most S&Ls used relatively short-term variable-rate deposits to make these long-term fixed-rate loans, the industry was in a very vulnerable position when the economy deteriorated and interest rates rose sharply in the late 1970s.

Despite efforts by the industry to create loan structures that minimized the effects of high rates on consumers, S&Ls lost millions during this period. These problems became so severe that the industry was allowed to enter new lending fields and diversify their loan portfolios. Unfortunately, many of these new business areas were riskier than traditional mortgage finance, and managers had to acquire new skills to participate in them profitably. The fact that hundreds of S&Ls became insolvent during the 1980s showed that not all associations successfully made the transition. While fraud played a role in some S&L failures, the vast majority of these insolvencies resulted from ill-advised lending decisions and the inability of managers to respond to the problems associated with rapid growth. Significantly, a common trait among the thrifts that survived the 1980s was that they approached deregulation more cautiously and remained focused on meeting the consumer finance needs of their local service territories.

The process of how thrifts refined their operating and management procedures reveals that both external forces and internal initiative drove change. For the first one hundred years of the industry's existence, thrifts faced few competitive challenges, in part because they were relatively small and narrowly specialized financial institutions. After World War II, however, competitive pressures from commercial banks and the federal government forced thrifts to adopt more formal business procedures, and in the extreme to rethink their mission as financial institutions. Some responded by offering services that made them virtually identical to banks, while others remained focused on providing home mortgages and consumer loans. Other innovations occurred because managers were proactive. S&Ls were among the first financial institutions to offer fully amortizing mortgages, a very consumer-friendly form of finance, and pay compound interest on deposits. Similarly, their emphasis on service led thrifts to pioneer the use of drive-up windows, branch offices, and consumer technology such as automated teller machines.

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The second theme examines the role of the national thrift trade association in the development of the industry.<sup>10</sup> While thrifts organized local, state and regional trade groups to promote their business interests, it was the United States Savings and Loan League, the industry's national trade group that proved to be the most influential. Like trade associations in other industries, the League began as an informal organization whose chief function was to act as a forum for thrift leaders to meet. This role changed significantly in the 1920s and 1930s, as the League assumed new responsibilities that included the development of uniform business practices in accounting, real estate appraising. It also played a larger role in publicizing both the industry and the ideals of thrift and home ownership. A key figure in this transformation was Morton Bodfish, who led the League from the late 1920s to after World War II. His organizational improvements gave the trade group the capacity to take a leading role in the industry's growth after the war.

The League was at its height of power in the 1950s and early 1960s when thrifts were emerging as an important source of consumer finance. Under the leadership of Norman Strunk, the national trade association continued to portray thrifts as modern, innovative, and local financial institutions. Such efforts helped the industry attain its present status as a dominant source for long-term home finance and a major repository for savings. As the industry grew, however, the League's work was hindered by the competing interests of large and small thrifts, which limited its ability to present unified positions on political and business issues. One consequence of this industry disharmony was that the League played only a nominal role in the process of deregulation. Although the League regained its political influence in the 1980s, the severity of the S&L crisis discredited the trade group and in 1991 it was disbanded.

Despite the broad successes achieved by the League during its nearly one hundred years of existence, this study clearly shows that industry support for its national trade association was very inconsistent. During the early twentieth century, the League often encountered stiff resistance from members in its efforts to change industry practices. Similarly, the creation of the system of federal regulation required the League to not only lobby Congress, but also wage an extensive promotional campaign to convince thrifts how various governmental programs would benefit them. Another important characteristic of the League's history was that even though a majority of all thrifts belonged to the trade association, its policies usually favored the interests of its largest members. This growing inability to represent the needs of smaller

<sup>10</sup> Seminal studies on trade associations include Louis Galambos, *Competition & Cooperation: The Emergence of a National Trade Association* (Baltimore: Johns Hopkins Press, 1966); William R. Childs, *Trucking and the Public Interest: the Emergence of Federal Regulation, 1914–1940* (Knoxville: University of Tennessee Press, 1985); Robert F. Himmelberg, *The Origins of the National Recovery Administration: Business, Government, and the Trade Association Issue, 1921–1933* (New York: Fordham University Press, 1993).

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thrifts was critical in the formation of competing trade associations that challenged the League's authority.

The third theme focuses on the evolution of relations between the thrift industry and government. Thrift leaders, like those in other financial industries, generally regarded government regulation as both a blessing and a curse. While they approved of measures designed to protect and promote their business, they also wanted the government to give them free reign to grow and broaden operations. Thrift regulation first began in the late nineteenth century at the state level. Initially it was well received because state oversight helped limit competition and produced more uniform business practices that, in turn, increased public confidence. The economic turmoil of the Great Depression led to federal regulation of thrifts, and by 1934 S&Ls had the support of a central reserve credit bank, a program of deposit insurance, and a system of federal chartering. Significantly, League leaders took an active role in designing these laws, which they saw as important in protecting thrifts from competition and promoting their growth. Furthermore, because the League used the close ties it developed with regulators over the years to influence the formation of thrift regulations, some observers claimed that the industry had captured these agencies.

The most recent period of major change in government-business relations happened in the 1980s, when Congress deregulated the thrift industry. Following the financial losses associated with the unprecedented changes in interest rates in the late 1970s, regulators realized that a more flexible system of regulation and oversight was needed if the thrift industry was to remain strong. Significantly, commercial banks, investment banks, and financial services firms faced many of the same challenges as S&Ls, and all these industries underwent dramatic change during the decade. The goal of deregulation was to make thrifts more competitive by allowing them to diversify their loan portfolios into areas beyond consumer finance. These included the right to make commercial loans, hold junk bonds, and make direct equity investments in real estate.

Financial deregulation was not, however, a straightforward process. Because the federal government insured the deposits of both thrifts and banks, legislators had to ensure that allowing these firms to enter new business areas would not result in greater risks to the insurance funds. Consequently, when regulators relaxed the restrictions on thrifts, they should also have increased the level of oversight and enforced greater lender discipline. Unfortunately, regulatory supervision of S&Ls declined in the early 1980s for a variety of reasons, and despite efforts to impose stricter controls beginning in 1984, industry oversight at both the state and federal levels remained inadequate. Consequently, lenders who made well-intentioned but ill-advised loans were not held strictly accountable for their actions, and managers intent on fraud found it easier to commit their illegal acts. The result was one of the worst financial disasters in American history that has directly cost taxpayers



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more than \$160 billion to resolve. Given the magnitude of the thrift crisis, in 1989 Congress imposed greater restrictions on thrifts, and while not complete re-regulation the new rules were intent on refocusing S&Ls on their core mission of providing home finance.

The analysis of thrift oversight reveals two consistent characteristics. First, changes in the level of government regulation were rarely proactive but rather came in response to economic downturns and industry crises. State oversight of thrifts began after the Depression of 1893, federal regulation occurred during the Great Depression, and deregulation was driven by rising interest rates in the late 1970s. The second trend was that when change did occur, larger S&Ls tended to be among the first to utilize the benefits of regulation and deregulation, while smaller associations took a more deliberate “wait and see” attitude. For example, it took nearly twenty years for a majority of thrifts to become members of the federal deposit insurance system. While internal disagreements over the level of regulation were not unique to the thrift industry, they also often reflected broader divisions within the industry.

The final theme in this study focuses on the role savings and loans played in promoting home ownership and popularizing the home as one element of the “American Dream” of individual home ownership. When industrialization in the nineteenth century allowed for the separation of commercial and domestic activities, the image of the home underwent a radical transformation. Rather than being a place where family and work chores occurred simultaneously, the home came to be regarded as a distinct environment where parents could focus on raising children. Interestingly, the “new” family-oriented home also became the place where people learned the moral values that made them good citizens. Thrifts readily identified with the changed image of the home, and by the 1890s were publicizing to working-class men and women how owning a home offered not only financial security and a healthy place to raise a family, but also led to greater personal self-esteem and ultimately a stronger country. This image was best captured in the slogan for the national thrift trade association – “The American Home. The Safeguard of American Liberties.”

Aside from popularizing the idea that thrifts produced “good Americans,” the industry played a major role in changing where Americans wanted to live. One trend in the demographic history of the United States has been the steady movement of people from rural to urban and suburban areas. While the growth of cities and suburbs required a variety of changes, ranging from improvements in transportation to how homes were built, the availability of affordable financing was also critical. The “democratization” of the home loan by the thrift industry, which involved making it easier to qualify for and repay a mortgage, helped transform suburbia from a nineteenth-century retreat for the rich to the predominant residence for the twentieth-century middle class. It also helped give the United States one of the highest percentage



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of private home ownership in the world and helped make home equity a major source of household wealth.

It clearly would be an exaggeration to claim that S&Ls were responsible for changing how Americans viewed the home, or determining where people wanted to live, but it is fair to say that the romantic ideals held by many thrift leaders allowed the industry to play a crucial role in shaping these processes. For the first one hundred years of the industry's existence, S&L publications emphasized thrifts as being part of a social uplift movement that was more concerned with improving people's lives than making a profit. While this belief was greatly eroded by the 1950s, S&L managers continued to stress their commitment to the local community as the key difference between their institutions and other financiers. Even at the end of the twentieth century, these ideals still resonate with consumers and remain a defining characteristic of the industry.

I have divided this work so that each chapter focuses on a major period of change or innovation. Chapter 1 traces the development of thrifts during the nineteenth century and focuses on four major topics: how and why the thrift industry began, why savings and loan leaders cultivated an image of their business as a self-help movement, the role of women in encouraging industry growth, and the rise and fall of "national" thrifts and their impact on the industry. Chapter 2 covers the years 1900 to 1929, a period when the national trade association emerged as the true leader in the thrift industry. The major topics include how the trade association encouraged thrifts to adopt more uniform business practices, its efforts to promote thrift development and home ownership, the rise of ethnic savings and loans, and how the prosperity of the 1920s affected the thrift industry.

Chapter 3 analyzes how and why state and federal regulation began, and the effects these laws had on the industry. Because thrift leaders played an active role in securing regulation, the programs created often protected and promoted industry interests. Still, not all managers agreed on the need for regulation, and the League worked hard to gather industry support for the federal programs to ensure their success. Chapter 4 focuses on business and organizational changes from 1930 to 1945 and includes an analysis of how the industry dealt with the financial hardships of the Great Depression, as well as the competitive challenges associated with increased federal involvement in home finance. Chapter 5 covers the first decade after World War II, which is generally considered the thrift industry's "glory years." This section details how the industry took advantage of the natural postwar demand for housing to become the dominant institutional source of residential finance in the country. While the growth of suburbia was important to this expansion, League promotional activities, favorable regulations, and innovations by individual thrift managers also contributed to this process.

Chapters 6 and 7 analyze the events of the twenty-five years that preceded deregulation of S&Ls in the 1980s. While the industry continued to

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post steady growth, an overarching theme is the widening gap between large and small associations. Among the sources of disagreement were, first, how to respond to the competitive threats posed by commercial banks and federal housing programs, and second, how best to utilize an ever-increasingly growing array of technological innovations. At the same time, the industry had to contend with the problems associated with greater regulatory scrutiny and congressional actions that included the loss of their tax-exempt status and the imposition of interest rate controls. This section ends with a review of how the unprecedented economic problems of the 1970s affected the industry and contributed to thrift deregulation.

Chapter 8 focuses on thrift deregulation and an overview of the S&L crisis of the 1980s. A review of key legislation passed during this decade and the events surrounding the failure of hundreds of thrifts provides evidence that this financial debacle resulted from a combination of forces, and that there is no one dominant cause. While fraud was a factor in the failure of dozens of thrifts, bad lending decisions and lax supervision were clearly the leading causes of insolvency. Chapter 9 discusses thrift re-regulation and examines the efforts to liquidate the billions in assets held by insolvent thrifts. It includes a critical assessment of the major reasons why thrifts failed, and examines the state of the thrift industry toward the end of the twentieth century. Chapter 10 concludes the study by evaluating the overall roles that regulators, trade groups, outside competitive pressures, and internal forces played in shaping the development of the thrift industry during its long history.

An appendix includes case studies of two savings and loan associations, which are intended to illustrate elements of success and failure in the industry. The first is of Empire Saving and Loan Association, a thrift located near Dallas, Texas, which failed in 1983 as a result of criminal activity. An analysis of this insolvency reveals that, although management fraud was critical to the collapse, an equally important factor was the inability of regulators to intervene in a timely manner. The second case study is of Medford Cooperative Bank, near Boston, which was formed in 1887 and continues to profitably meet the financial needs in its local community. This analysis reveals that a key reason for success was that it was committed to serving the financial needs of the local community it served, a trait that traditionally has been associated with the thrift industry.

My examination of the American savings and loan industry indicates that thrifts have served, and continue to serve, a vital function in this country's financial system. Thrifts are responsible for perfecting the system of home finance that has become the standard used by the federal government and all other home lenders. Also, by making mortgages affordable to ordinary Americans, thrifts made owning a home a reality for millions of families and in turn helped make home ownership the chief source of household wealth. At the same time, because thrifts are the only financial institutions that trace