International Economics 122 (2010), p. 57-88

INTERNATIONAL
ECONOMICS
ÉCONOMIE INTERNATIONALE

Is there a link between the American S&L crisis of the 80s and the subprime crisis? An analysis of bank returns

Loredana Ureche-Rangau[1] & Aurore Burietz[2]

Article received on April 26, 2010
Accepted on October 10, 2010

Abstract. Between 2000 and 2002, the American Federal Open Market Committee has strongly decreased its target rate. This decrease, associated with external economic factors as well as innovative financial practices has influenced investors' behaviour. In this paper, we analyze the financial causes of the subprime crisis, in comparison with the American S&Ls crisis of the 1980s. We perform an event study on banks returns and show that only the monetary policy of the FED, *i.e.* interest rates, seems to have influenced, to some extent, these returns. Our analysis also stresses how securitization practices may explain one of the noticeable differences between the S&L crisis and the subprime crisis' consequences while their origins seem to be similar.

JEL Classification: G22; G30; G32; G38.
Keywords: Subprimes; Savings and Loans; Securitization; Bank returns; Credit risk.

Résumé. Entre 2000 et 2002, la Réserve Fédérale Américaine a procédé à des réductions significatives de son taux directeur. Ces diminutions, couplées à des facteurs économiques externes ainsi qu'à des pratiques financières innovantes ont considérablement influencé le comportement des investisseurs. Cet article propose une analyse des causes financières de la crise des subprimes, en parallèle avec la crise des Caisses d'épargne américaines des années 1980. Nous réalisons une étude d'événement sur un échantillon de banques et montrons que seule la politique monétaire de la FED, *i.e.* les taux d'intérêt, semble avoir influencé, d'une certaine manière, ces rentabilités. Notre analyse met également en lumière la manière dont la titrisation peut expliquer l'une des différences majeures entre les conséquences des deux crises alors que leurs origines s'avèrent assez similaires.

Classification *JEL* : G22 ; G30 ; G32 ; G38.
Mots-clefs: Subprimes ; Caisses d'épargne américaines ; rentabilités bancaires ; risque de crédit.

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1. Université de Picardie Jules Verne, CRIISEA, Pole Universitaire Cathédrale, 10 placette Lafleur, BP 2716, 80027 Amiens Cedex 1, France, loredana.ureche@u-picardie.fr, phone : +33 3 22 82 68 03, fax : +33 3 22 82 71 13.
2. Ieseg School of Management, 3 rue de la Digue, 59000 Lille, France, aurore.burietz@ieseg.fr, phone : +33 3 20 54 58 92, fax : + 33 3 20 57 48 55

1. Introduction

The current financial markets turmoil renews the interest in looking for potential explanations of the factors that contributed to the initiation and development of such a phenomenon. This search is motivated by the hope that once the causes are exactly identified, solutions would become obvious for putting an end to the fall and, moreover, for preventing such cataclysms to appear again in the future. As often during periods of financial distress, one turns back to historical evidence. History repeats itself and one can always find a link with past events despite some particular features that appear to be different.

In the specific case of the subprime crisis, one could therefore wonder whether we already saw this type of financial downturn in the past and whether the causes, consequences and potential solutions are comparable. While comparisons with the well known great depression of the 1930s were already advanced, there seems to be, in our opinion, another financial crisis that appears quite close, at least in terms of causes, to the events that we have all experienced since the summer of 2007. Historical evidence shows that during the 1980s, the American financial market experienced a real estate and credit bubble that dramatically affected mainly banks and Savings and Loans institutions (S&Ls hereafter). However, its economic consequences were restrained to the North American continent with very limited spillovers over the world. Both the S&Ls and the subprime crisis seem to have the same origins that include external influences and government intervention to regulate the market. However, some differences can be identified, which may explain the larger impacts of the subprime crisis on the world financial markets.

Cross check of the S&Ls and subprime crises potential causes

While the causes of the subprime crisis were already the subject of many debates both within the public opinion and the academic circles[3], it seems interesting to remind some facts concerning the origins of the S&Ls crisis and its development.

Following the Great Depression of the 1930s, an important number of banking laws and regulations were introduced in the US in order to provide financial markets with liquidity, safety, efficiency, public convenience and stability (Hamlin and Hillyard, 1991). Within this new regulatory framework one could mention the Federal Home Loan Bank Board (FHLBB) created by the Congress in 1932 in order to sustain financial markets, to control thrifts institutions and to allow them to get to the secondary market for mortgages (Marcis, 1974; Hamlin and Hillyard, 1991; McCool, 2005), the Glass-Steagall Act of 1933 or the Federal Deposit and Insurance Company (FDIC) in 1933 with the main objective of providing liquidity by insuring commercial bank deposits. While until 1934 S&Ls managed to remain safe and to insure the necessary liquidity to the markets *via* their activity of receiving deposits and offering mortgages, *i.e.* a low risk activity after all, the creation of the Federal

3. For very interesting and complete analyses of the mortgage and housing markets and the roots of the subprime crisis, please refer to Chomsisengphet and Pennington-Cross (2007), Tully (2007), Crouhy, Jarrow and Turnbull (2008), Thompson (2008), Daglish (2009) or Okongwu and Sabry (2009) among others.