



Economic Review

Government Assistance and Moral Hazard: Evidence from the Savings and Loan Crisis

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In 1989, the U.S. government ceased assistance to failed savings and loans, leading many of these institutions to reduce their risk-taking.

When regulators intervene to rescue failing financial institutions, they may lead banks to expect future assistance and increase their risk-taking. To avoid incentivizing risky behavior, regulators often try to signal that they will not assist banks in a future crisis. Regulations passed during the savings and loan (S&L) crisis in the 1980s provide a rare example of policies that in fact discouraged risk-taking. After a wave of S&L failures, the Federal Savings and Loan Insurance Corporation (FSLIC) liquidated or sold some failed S&Ls but assisted others to keep them in operation. In 1989, however, the FSLIC closed. A new regulatory agency was prohibited from assisting failed institutions, which signaled the suspension of future assistance.

Padma Sharma examines how suspending assistance to failed S&Ls in 1989 affected the balance sheets of operational S&Ls. She finds that S&Ls responded to the change in policy differently depending on ownership structure: stock S&Ls increased their composition of safe assets relative to mutual S&Ls. If government assistance had remained feasible, stock S&Ls likely would have continued taking risks, lending an additional \$2.14 billion and reducing their holdings of securities by \$4.5 billion. In contrast, mutual S&Ls did not engage in excessive risk-taking even when government assistance was feasible, so they had little incentive to further reduce risk-taking when assistance was suspended.

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