

HARD LESSONS, STRONGER BANKS

The enduring wisdom of the Savings and Loan crisis veterans.

Bank CEOs who experienced the 1980s Savings and Loan (S&L) crisis managed their banks more conservatively, reduced systemic risks, and delivered superior performance during the 2008 Global Financial Crisis (GFC).

Financial supervisory bodies may consider crisis experience as a factor when evaluating bank leadership transitions.

Policymakers should encourage board diversity in financial institutions through the hiring of crisis-experienced directors, and design interventions that preserve crisis wisdom while maintaining healthy risk appetites for economic growth.

Crisises are not rare occurrences in financial markets. One commonly held notion is that financial institutions' substantial exposure to risk caused the 2008 GFC. Yet some banks fared well during this crisis. Is there something unique about the risk-taking seen at these banks? There has been considerable evidence on some of the institutional determinants of banks' risk-taking behaviour and performance, such as financing, governance, and culture, but the influence of CEOs' experience on bank performance and risk-taking behaviour appears to have been overlooked.

History shows that crises provide powerful lessons for bank leaders. Those who have endured crises often emerge with sharper instincts and a keener sense of risk, guiding their institutions more effectively through future storms. My research examines how one of the most devastating banking collapses in US history – the 1980s S&L crisis – shaped the leadership style of bank CEOs and influenced the decisions they made decades later, including during the 2008 GFC.

Drawing from established research on experience-based learning, this study tests a central conjecture: *bank CEOs with greater exposure to past banking crises subsequently manage their institutions more conservatively and achieve superior performance during future crises.* What appears to have happened is that these CEOs actively acquire lessons from the intense and rare experience during a crisis, and become more cautious about areas that caused the systemic fallout.

Such learning and adjustment of risk attitudes by bank leaders are critical for the banking sector. Banking crises typically arise when industry leaders collectively ignore embedded risks in widespread practices, such as deteriorating lending standards and excessive leverage. These crises thus represent the ex-post realisation of systemic risk that accumulates gradually before manifesting as system-wide failures.

Crisis experience could theoretically have the opposite or no effect. CEOs with greater exposure to past banking crises might engage in 'gambling-for-resurrection' behaviour, becoming more tolerant to risks and taking excessive risks in managing their banks. Alternatively, they might function primarily as implementers of predetermined institutional strategies, rendering their personal experiences irrelevant to organisational outcomes. Understanding which factors drive risk-taking behaviour in relation to executive experience provides insights for designing more resilient financial systems.

ORIGINS OF THE S&L CRISIS AND RESEARCH DESIGN

The 1980s S&L crisis offers a compelling setting for examining experience effects on executive behaviour. It stands out as one of banking's most destructive episodes, though it is often overshadowed by the 2008 financial collapse. The crisis emerged when multiple risk factors converged to create a devastating chain reaction (see box story).

THE S&L CRISIS

During the 1970s, several currencies moved from a fixed-rate regime to a floating-rate regime, and as a result, exchange rates became more volatile globally. In response to the oil embargo and other supply shocks, oil prices increased drastically. Concomitantly, interest rates gyrated wildly in response to inflation and expectations about inflation, as well as the anti-inflationary monetary policies adopted by the Federal Reserve System of the US (the Fed). When the Fed doubled the federal funds rate to reduce inflation in 1979, it further undermined the financial health of the thrift industry and Congress reacted by passing laws to deregulate it. The deregulation of deposit interest rates exerted upward pressure on banks' funding costs because both banks and thrifts relied on short-term funding; they had to compete for funds by offering higher rates to attract deposits. As the revenue from long-term, fixed-rate mortgages did not vary with short-term interest rates, this squeezed the profits of thrifts and commercial banks alike. Losses began to mount for these institutions.

At the same time, financial innovation reduced the profit margins in traditional banking.

Banks faced increased competition from new financial instruments, including money market mutual funds, the commercial paper market, and securitisation. As a result, many banks shifted their funds to commercial real estate lending, which generated not only higher returns but also greater risks. Some banks participated in leveraged buyouts and off-balance sheet activities. Futures, junk bonds, swaps, and other new financial instruments also facilitated greater risk-taking by banks. Deposit insurance exacerbated the moral hazard problem faced by banks, because insured depositors had little incentive to discourage banks from taking excessive risks.

As a result of such risky behaviour, thrifts and commercial banks began to suffer extensive losses. During the 1980s, the performance ratios of banks of all sizes deteriorated substantially while their assumed risks and loan charge-offs rose dramatically. Systemic distress followed, with many S&L customers going bankrupt and defaulting on their loans. The thrifts that had overextended themselves were forced into insolvency and a wave of bankruptcies ensued. The final toll was staggering – approximately 2,920 banks and thrift institutions failed or required federal assistance between 1986 and 1995. This included 1,043 of the nation's 3,234 S&L institutions and more than 1,600 FDIC (Federal Deposit Insurance Corporation)-insured banks. The clean-up cost taxpayers over US\$124 billion. Unlike a brief market crash, this was a slow-moving disaster that lasted more than a decade.²

Executives with decision-making authority during crises internalise more actionable lessons than passive observers.



For banking professionals who lived through this period, the S&L crisis provided an intense education in financial system fragility. They witnessed how interest rate mismatches, credit risks, liquidity problems, and regulatory gaps could combine to destroy seemingly stable institutions. This comprehensive exposure to multiple risk factors created learning experiences that proved invaluable decades later.

Research design

The S&L crisis possesses several characteristics that enhance its research value. First, significant parallels exist between the S&L crisis and the 2008 financial crisis – both featured real estate bubbles, deteriorating credit standards, and complex financial instruments that amplified systemic risk. This similarity suggests that lessons from the earlier crisis could prove directly applicable to later challenges. Second, the crisis extended across multiple years and affected virtually all US states, though with substantial geographic variation. This temporal and spatial heterogeneity creates rich cross-sectional differences in individual exposure levels suitable for empirical analysis.

Importantly, for the research design, the scale of the crisis varied across states and over time. Regional and sectoral downturns exacerbated the banking crisis, with bank failures traced back to different factors. For example, energy states like Texas and Oklahoma were devastated, while agricultural states like Iowa and Kansas suffered from farm recession.

The research design exploits geographic variation in crisis intensity to measure individual CEO exposure levels. For each CEO in the sample of 426 CEOs of publicly-listed US banks between 1995 and 2009, I reconstructed their employment histories at the height of the S&L crisis, tracking where they worked and how severe the crisis was in those states. This measure of ‘crisis exposure’ is based on the bank failure rate in each state at that time – a clean metric that captures the intensity of local turmoil beyond individuals’ reach and control.

This state-level approach sidesteps concerns about reverse causality – CEOs could not influence statewide failure rates. Unlike firm-level measures, state-level crisis intensity remains largely beyond individual CEO’s control, reducing the likelihood that unobserved factors simultaneously influence both crisis exposure and subsequent management decisions. The geographic variation also exploits the fact that many future CEOs relocated between states after the crisis, creating additional advantages for identifying causal effects of crisis experience on subsequent executive behaviour and institutional performance.

ONCE BITTEN, TWICE SHY

The results are clear. Bank CEOs who were intensely exposed to the S&L crisis ran their institutions more cautiously. Their banks carried less systemic risk, as measured by market beta and marginal expected shortfall,

two widely used indicators of vulnerability to market downturns. These banks also exhibited lower tail risk and reduced stock return volatility, reflecting a deliberate effort to avoid extreme losses and excessive risk in general.

The caution was not generic – it was domain-specific, focusing on the precise areas that had triggered the S&L collapse. Given that the interest rate risk, risky financial innovation, and credit risk contributed to the escalation of the S&L crisis, CEOs who witnessed the resulting industry fallout could learn the implications of such shocks and implement conservative policies in these areas. Crisis-experienced CEOs engineered business models that were more resilient to interest rate fluctuations: their banks’ stock returns showed lower correlations with LIBOR (London Interbank Offered Rate) shocks and their banks had lower ROA (Return on Assets) sensitivity to federal funds’ rate changes. Their banks were less likely to overextend into real estate lending; they also engaged less in derivative trading, and relied less on non-interest income. Conservative CEOs maintained non-performing loan ratios that were 22-23 basis points lower. This reduction of credit risk did not compromise bank profitability, suggesting that crisis-experienced CEOs set up a more efficient and stronger risk control system, and implemented stringent monitoring of loan quality. Finally, CEOs with greater crisis exposure also maintained stronger liquidity positions.

This conservative approach in normal times paid off during the 2008 GFC. My research shows that banks led by these ‘crisis-scarred’ CEOs outperformed their peers, delivering an average of 4.2 percentage points higher stock returns during the worst months of the downturn. They were also less likely to fail between 2007 and 2009, a period that saw some of the largest US bank failures in history. A CEO with a seven-percent S&L state failure rate (75th percentile) delivered 3.1 percent higher crisis returns than a CEO with a 3.1-percent S&L state failure rate (25th percentile). It was a similar story for operating performance. Banks led by conservative CEOs showed superior fundamentals during the crisis. They maintained higher ROA, held lower percentages of risky real estate loans, and crucially, maintained significantly higher liquid asset ratios.

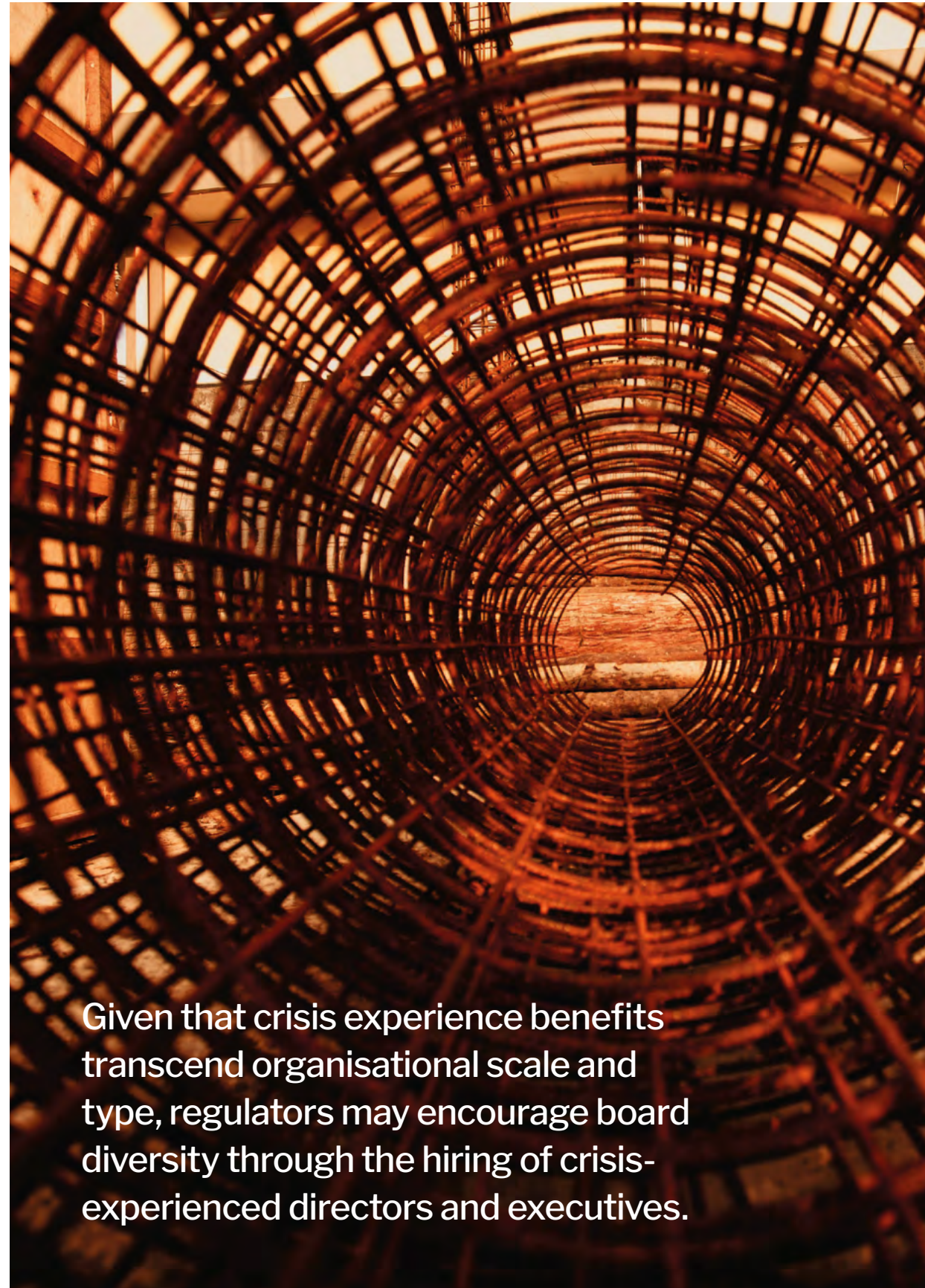
THE ROLE OF SENIORITY AND SECTOR EXPOSURE

Not all crisis experiences are created equal. The analysis reveals important variations in how crisis experience matters. CEOs who held C-suite positions during the S&L crisis showed significantly stronger learning effects than those in junior roles.

The dampening effect on risk-taking was amplified for executives who had decision-making authority during the crisis years. This finding supports the salience hypothesis – executives with decision-making authority during crises internalise more actionable lessons than passive observers. Executives who were forced to make consequential decisions under extreme pressure – whether about liquidity management, loan loss provisioning, or strategic repositioning – developed superior risk judgement that lasted decades.



While regulators cannot dictate CEO selection, they can incorporate crisis experience assessments into their supervisory frameworks, particularly during periods of institutional stress or when evaluating management quality.



Given that crisis experience benefits transcend organisational scale and type, regulators may encourage board diversity through the hiring of crisis-experienced directors and executives.

The research also reveals that banking sector experience during crises matters more than general economic exposure. CEOs who worked specifically in banks, thrifts, or other depository institutions during the S&L crisis showed stronger learning effects than those who experienced the broader economic downturn from other industries. This sector specificity suggests that crisis learning is most effective when individuals directly confront the institutional mechanisms that drive financial instability. Understanding how deposit runs unfold, witnessing regulatory intervention firsthand, or managing through asset quality deterioration provides insights that cannot be gained from observing crisis effects from outside the banking sector.

Importantly, the learning effects proved consistent across both large and small banks. This finding counters the notion that crisis learning only matters for smaller, more vulnerable institutions. Even large, systemically important banks benefitted from crisis-experienced leadership, suggesting that the insights gained transcend organisational scale.

ESTABLISHING CAUSALITY

One of the most critical aspects of this research lies in the rigorous approach to establishing causality – proving that crisis experience actually brings about better bank management, rather than simply correlating with it. This distinction matters enormously for business leaders seeking to apply these insights.

A sceptical observer might argue that the findings simply reflect selection bias: perhaps conservative banks hire CEOs with crisis experience, or risk-averse individuals who seek employment in crisis-affected regions. If true, the correlation between crisis experience and conservative management would tell us nothing about the causal impact of the experience itself.

The study addresses these challenges through multiple approaches. Perhaps most convincingly, even CEOs' birth state failure rates during the S&L crisis predict their later conservative management styles. Since individuals cannot choose where they are born, this birth state exposure approximates random assignment. The fact that hometown crisis experience – transmitted through social networks and information channels – influences later management decisions strongly supports a learning interpretation.

The research also leverages quasi-random CEO turnovers due to retirement to establish causality. When elderly CEOs retire due to ageing and health conditions, the exact timing and choice of their replacement creates plausibly exogenous changes in bank leadership crisis experience, i.e., the change in leadership was caused by the outgoing CEO retiring rather than a crisis, poor performance, or scandal, etc. Banks that appoint crisis-experienced CEOs through these retirement-driven successions subsequently adopt more conservative policies – evidence

that experience drives behaviour rather than vice versa.

The research includes sophisticated event studies showing that banks only become more conservative after crisis-experienced CEOs take office, not before. This temporal sequencing rules out the possibility that pre-existing institutional trends drove the selection of conservative leaders. The findings survive numerous alternative explanations, including CEO compensation, educational background, age, and other personal characteristics that might influence risk preferences.

Japan's experience and lessons for Asia

Although findings in this research are based on the US banking industry, they also provide interesting insights into other markets. In Japan, the geographical patterns of crisis experience and subsequent resilience mirror the findings in the S&L study.

Japan faced a major financial crisis in the late 1990s, with banks in western Japan hit significantly harder than those in the east. This regional disparity created a natural experiment similar to the state-level variations in the US S&L crisis. When the 2008 GFC – driven primarily by the collapse of structured products – struck, an intriguing pattern emerged: the GFC had a greater impact on eastern Japanese banks, while institutions in the western parts of the country proved more resilient.

This contrast strongly suggests that banks in western Japan, having borne the brunt of the 1990s

crisis, had developed institutional wisdom and conservative practices that served them well during the GFC. The parallel to my findings is striking – just as American bank CEOs who experienced severe S&L crisis exposure later managed more resilient institutions, Japanese banks that suffered through the 1990s regional crisis emerged better prepared for the next systemic shock.

However, Japan's experience also reveals the potential downsides of crisis-induced conservatism – a nuance that adds important context to my research. Japanese bank CEOs, having experienced past financial crises, often responded by becoming excessively conservative in their approach to risk management. This institutional scarring extended beyond banking, and companies across Japan, shaped by lessons from the financial crisis, adopted extremely cautious stances towards financial leverage.

This excessive conservatism is considered one of the contributing factors to the loss of 'animal spirits'³ in Japan's economy. The pendulum swung so far towards risk aversion that even productive investment and entrepreneurial activity suffered. Government intervention became necessary, with both fiscal authorities and the Bank of Japan (BOJ) stepping in to reallocate financial sector capital and encourage healthier levels of risk-taking.

Singapore Management University's Sim Kee Boon Institute for Financial Economics (SKBI) board member Takako Masai, who served five years

on the Policy Board of the BOJ, observes, "Japanese banks and companies need to strike a balance between learning from past crises and expanding their risk appetite to a healthy level. The experience of US banks serves as a valuable example."

The Japanese experience illuminates a critical nuance in the study – while crisis experience generally improves bank performance and risk management, institutions must guard against overcorrection. The optimal approach involves learning domain-specific lessons from past crises while maintaining appropriate risk appetites for value creation.

POLICY IMPLICATIONS

The research findings have potential implications for financial regulators, policymakers, and institutional leaders seeking to build more resilient banking systems.

Financial supervisors may consider crisis experience as a factor when evaluating bank leadership transitions. While regulators cannot dictate CEO selection, they can incorporate crisis experience assessments into their supervisory frameworks, particularly during periods of institutional stress or when evaluating management quality.

Given that crisis experience benefits transcend organisational scale and type, regulators may encourage board diversity through the hiring of crisis-experienced directors and executives. This represents a form of human capital regulation that could significantly enhance systemic stability.

The Japanese experience also warns against excessive conservatism following crisis learning. Policymakers can design interventions that preserve crisis wisdom while maintaining healthy risk appetites for economic growth.

The research ultimately demonstrates that financial crises, while destructive, create invaluable human capital in the form of crisis-experienced leaders. Personal exposure to financial crises can shape bank CEOs' risk attitudes and risk management styles, fostering more resilient and prudent banking practices. Policymakers who recognise this reality and design systems to capture, preserve, and deploy this wisdom will build more resilient financial systems capable of withstanding future shocks while supporting sustainable economic growth. ^{AMI}



DR GLORIA YANG YU

is Assistant Professor of Finance at Lee Kong Chian School of Business, Singapore Management University

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