Beyond the Savings-and-Loan Crisis
Beim, David O.
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Beyond the savings-and-loan crisis

DAVID O. BEIM

IT IS TIME someone said it out loud: the thrift industry can no longer be justified as an entity separate from banking.

It has been in crisis for nearly a decade. While there are certainly some healthy thrift institutions, there are so many weak and dying ones that they can no longer be sustained by any existing mechanism. The industry's entire net operating income—pre-tax earnings *before* loan losses—was probably no more than $1.5 billion in 1988. A significant further rise in short-term interest rates would more than erase that income. The industry's entire equity capital is stated at $28 billion, but much of this figure represents useless assets such as good will. Overall, the industry's interest-bearing liabilities exceed its interest-earning assets by $78 billion.

The ultimate cost of thrift failure—whether it turns out to be $90 billion, $110 billion, or more—is monstrously high. I am not concerned here with the allocation of this cost, except to note that the thrift industry itself lacks the resources or earning power to pick up very much of it. Instead I would like to explain what is fundamentally wrong.

The principal culprit is usually held to be weak regulation. Thrift regulators have undeniably been overindulgent and understaffed. They have maintained too close and solicitous a relationship to their industry. If the problem were merely poor regulation, it could readi-

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ly be fixed. Unfortunately, though, the problem is far more deeply rooted: *the business definition of a thrift no longer works*. Nonetheless, the Federal Savings and Loan Insurance Corporation (FSLIC) continues to back the thrift industry through federal deposit insurance.

The historic role of thrifts

Thrifts include savings and loan associations (S&Ls) and savings banks. There are presently about 3000 S&Ls and about 400 savings banks in the country, with total assets of about $1.2 trillion—approximately one-third those of commercial banks.

Historically, virtually all thrifts were mutual organizations—privately held companies organized for the mutual benefit of their members. S&Ls originated in Great Britain and spread to the United States in the nineteenth century. Here they have played a historic role, for they were once the only sources of long-term capital for home building. The availability of home-mortgage financing let millions of Americans build and own homes, helping to make America a nation of homeowners.

Savings banks, the other wing of the thrift industry, were organized to encourage new immigrants to save part of their wages to gain financial security. They are concentrated in the Northeast, where most immigrants arrived. In contrast to commercial banks, which concentrated on "demand deposits" and provided short-term liquidity, thrifts took longer-term savings deposits and provided longer-term loans—primarily home mortgages—to individuals.

From 1933 until recently, banks were somewhat sheltered from financial markets, but thrifts were even more sheltered. Few competing lenders wanted to make home-mortgage loans, and individuals who wanted to earn interest on savings had few alternatives to using thrifts other than purchasing bonds through brokers, a process that doubtless frightened most of them. Savers naturally turned to thrifts, which were seen as stable and reliable institutions. Long-term savings funded comparatively stable long-term investments.

Unfortunately, the funding of thrifts was never as long-term as it appeared to be. The first thrifts were funded entirely by members' equity; that is, members were obliged to leave their savings with the association semipermanently. Had this arrangement continued, the present crisis might have been avoided. But most people who put their money in thrifts wanted the right to withdraw it at will. Thus the funding of thrifts gradually changed from equity to savings deposits. These deposits are stable only until the world changes; then they can become surprisingly short-term.

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In the 1930s, for instance, savers withdrew their funds in great quantities, causing nearly two thousand thrifts to fail. As a result, the Federal Home Loan Bank (FHLB) system was established to provide liquidity to the thrifts as needed. The Federal National Mortgage Association (FNMA) was also formed as a private company with federal sponsorship to create a secondary market in mortgages, so that the assets of thrifts would be more liquid. In the 1960s, FNMA began to experiment with a new system to provide even more liquidity. It purchased mortgages and combined them into large pools. Pass-through interests in the pools were then sold to true long-term lenders, such as life-insurance companies and pension funds. The era of mortgage-backed securities had begun.

These developments were perfectly appropriate. Thrifts are not the best permanent holders of long-term mortgages, because their funding can be withdrawn at will. But the more suitable lenders were not major players in the home-mortgage business, because of the "retail" nature of mortgages. The great contribution of mortgage-backed securities was to create a conduit from the mortgage originators, primarily thrifts, to the ultimate long-term lenders. This development was a great relief to the thrifts. It let them rely more comfortably on short-term deposits—a giant step toward making them more liquid, like banks.

During the 1970s and 1980s the market for mortgage-backed securities grew beyond anyone's expectations. Aggressive and imaginative investment bankers pooled and repackaged mortgages of all descriptions, creating layers of interrelated securities and residual interests in mortgage pools. The market became so efficient, and mortgage securities became such attractive alternatives to corporate bonds, that bond-market movements now establish the value of mortgages.

In short, thrift assets have come to be market commodities, not private loans. Events far removed from real estate can cause bond prices to fluctuate, and these fluctuations are now quickly reflected in the value of thrifts' assets.

While thrift assets were changing from private loans to market-driven instruments, the nature of deposits was changing, too. From 1933 until 1980, the interest rate that banks and thrifts could pay on time deposits was fixed by the Federal Reserve. Thrifts, in fact, were favored by this system, which permitted them to pay 1/4 percent more than banks.

When interest rates rushed upward in the late 1970s, however, savers soon discovered that market-based instruments provided much

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higher yields than regulated deposits. The most attractive alternative to regulated deposits was the money-market funds. In the ten years after 1977, money-market funds grew from $4 billion to $255 billion, largely at the expense of banks and thrifts. Thrifts in particular faced a new liquidity crisis.

Congress responded by repealing interest-rate ceilings, so that banks and thrifts could bid openly for deposits. This reform was fine for banks, whose assets were largely short-term or floating-rate. The hapless thrifts, however, were loaded with 5 and 6 percent fixed-rate mortgages, whose funding was now to be provided by deposits at the market rate of 7 percent or more. In 1981 the thrift industry as a whole had operating losses of $7.1 billion, and in 1982 it lost $8.8 billion. In 1982 there were 252 thrift failures, and another 102 followed the next year. These losses and failures are the root of the current thrift crisis.

The present crisis was destined to occur sooner or later; it was totally predictable. The funding of long-term, fixed-rate mortgages with short-term deposits has always been very risky. It lasted so long because the United States enjoyed stable interest rates for a hundred years, from Reconstruction to the late 1960s.

Market banking is a creative response to the present instability of interest rates. It enables thrifts to react more quickly and flexibly to changing conditions. But it also squeezes the profit out of their traditional business.

The business definition of a thrift

The prospectus of a typical thrift describes the business with words such as these: "XYZ Savings and Loan Association is in the business of spread lending—earning income from the difference between interest paid on deposits and interest earned on mortgage lending." A bank prospectus, by contrast, speaks of a wide variety of customer services, including transaction accounts, trust and custody arrangements, and consumer and commercial loans. To be sure, banks make their money on spread lending as well, but they do so in the context of a broader service business. If you separate spread lending from customer service, which many thrifts try to do, you will not have a profitable business in an efficient market.

Financial markets today are efficient. That is their great virtue; they provide borrowers with the lowest possible rates and depositors with the highest possible rates. But in doing so they limit the attractiveness of spread lending, narrowly defined.

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In a certain sense, the thrift business has become too easy, and thereby profitless. A new thrift can be opened almost immediately, since a charter is easily obtained. No real customers are needed: federally insured deposits can be sold in $100,000 pieces through brokers, with the deposits being invested in publicly traded mortgage-backed securitites.

Such a business, which resembles many thrifts in operation today, adds no value to the economy and so cannot be profitable in the long run. If it is profitable in the short run, it is only because of the speculative risk being run.

Lending institutions can take two different kinds of risk: credit risk and interest-rate risk. Credit risk is incurred when institutions lend money to people who may not pay it back. Interest-rate risk, on the other hand, is incurred when deposits have a shorter repricing maturity than assets: if an institution accepts a six-month deposit at 8 percent and buys a ten-year bond at 10 percent, it makes money only until interest-rate increases force it to replace its short-term deposit at a loss.

Traditional thrifts take little or no credit risk, since mortgages are high-quality credit. But they take a great deal of interest-rate risk. In an age of efficient markets, this strategy is virtually certain to lead to losses at some point in each economic cycle. That point is the period—like the one we are in now—when the Federal Reserve tightens the money supply and short-term rates rise.

Banks generally follow the reverse strategy: they take little interest-rate risk but lots of credit risk. Their business too has become less profitable under market banking, for they have had to take more credit risk than ever before. But at least their strategy, if carefully implemented, has a chance of succeeding—especially if the credit risk is local and nonmarket.

Concentrating on credit risk also offers the strategic advantage of diversification, which can be the key to survival: even if one ship sinks, others may remain afloat. Interest-rate risk, however, cannot be diversified, since rate changes affect all long-dated assets simultaneously. Traditional thrifts are therefore playing Russian roulette.

The same logic applies to governmental deposit insurance. If one bank fails on bad credits, others may remain perfectly healthy. But when one thrift loses money on interest-rate risk, other thrifts tend to lose money at exactly the same time. Such simultaneous losses put the government in an impossible position.

If thrifts and their insurer are to survive, they must be permitted to take less interest-rate risk and more local credit risk. This is the

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direction in which most thoughtful thrifts have been moving, and the laws have been liberalized to allow the transition. These thrifts are taking another giant step toward becoming banks.

Unfortunately, markets are tough. If you are going to take credit risk, you must have a staff of lending officers with credit experience who know their borrowers. Only the most sophisticated thrifts have now built such staffs. Too many thrifts jumped into the credit-risk game without sufficient preparation when it opened to them. From 1982 to 1984, brokers peddled to thrifts vast numbers of high-return loans for the acquisition, development, and construction of real estate ("ADC loans"). Again, this business was too easy to be profitable, and a large proportion of the ADC loans have now defaulted. The problem is not just that the Southwest region—to which most of the loans went—is troubled, but that the thrifts were trying to do something that is generally impossible: make easy money through market banking. There is no substitute for building a real business with real customers and real services.

Mortgage origination

Market banking has not only squeezed the profit out of spread lending. It has also made mortgage origination a big-company business, national in scale.

The triumph of mortgage-backed securities has separated the business of mortgage origination from the business of lending. Anyone, not just thrifts, can now originate mortgages without having to hold them for more than a few months; capital can be furnished by outside lenders. Although this development has allowed thrifts to become more liquid, it has also invited a vast number of new players into the business of mortgage origination.

Thrifts used to account for the great majority of mortgage originations in the United States. Today they account for less than half, and their share is generally falling. While some of the giant thrifts have made mortgage origination their primary business and have increased their market share, most ordinary thrifts find it very hard to compete with them and the banks, insurance companies, finance companies, independent mortgage bankers, and financial conglomerates that have entered the mortgage-origination business over the past five years. (See Table.)

Citicorp, the nation's largest banking company, has become the leading originator of home mortgages simply by throwing its considerable resources into the origination business. It is true that Citicorp and other banks may not hold these mortgages for more than a brief

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Table. Leading one-to-four family mortgage-loan originators in 1987[a]

Company	*Volume (In billions of dollars)*	*Market Share (In percentage)*
Citicorp	14.8	3.3
H.F. Ahmanson & Co.	10.8	2.4
Great Western Financial Corp.	8.2	1.8
Fleet/Norstar Financial Group	7.5	1.7
GlenFed Inc.	5.3	1.2
CalFed Inc.	4.6	1.0
CityFed Financial Corp.	4.6	1.0
Dime Savings Bank of New York	4.4	1.0
Sears, Roebuck and Co.	4.3	1.0
Home Owners FSLA	3.6	0.8
Countrywide Credit Industries, Inc.	3.5	0.8
Chase Manhattan Corp.	3.5	0.8
Imperial Corp. of America	3.3	0.7
Goldome FSB	3.2	0.7
Shawmut National Corp.	3.0	0.7
Weyerhaeuser Co.	2.9	0.6
Primerica Corp.	2.8	0.6
Financial Corp. of America	2.8	0.6
Ford Motor Co./First Nationwide Bank	2.7	0.6
Home Federal SLA	2.7	0.6
General Motors/GMAC Mortgage Corp.	2.7	0.6
Meritor Financial Group	2.6	0.6
Commonwealth Mortgage Corp.	2.6	0.6
TransCapital Financial Corp./Transohio SB	2.4	0.5
Bank of Boston Corp.	2.4	0.5

[a] *Source*: SMR Research Corporation.

period; but commercial banks—especially those that are strapped for capital—may in fact start holding more mortgages in their portfolios, because of new international reserve requirements that let banks lend twice as much money in mortgages as they could in general loans.

Mortgage lending has long been the distinctive service offered by thrifts. As banks become increasingly involved in issuing mortgages, another important distinction between banks and thrifts is vanishing. Yet the special role of thrifts in mortgage lending has been the basis of their political support. Edwin J. Gray, former chairman of the FHLB Board, put it very well in 1983:

> The Federal Home Loan Bank System and its deposit insurance ally, the FSLIC, continue to exist—and can only continue to exist—in order to support the mortgage-finance function. There is no other reason for their existence. . . .
>
> There are those in this industry who believe their institutions ought to be allowed to engage in virtually any bank-like activity they wish. . . . [But] to the extent that Congress were ever to come to believe . . . that institutions the Home Loan Banks assist no longer strongly emphasized home-

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ownership opportunities, then the system would no longer be able to count on Congress for its continued support.

The system itself would be in jeopardy and the day of its demise would accelerate. . . . [Y]ou simply cannot have it both ways.

The law therefore requires that 60 percent of thrift assets be "qualified thrift assets"—primarily housing-related paper and government securities. Given these requirements, and the foolishness of taking long-term interest-rate risk, what strategy can thrifts adopt?

Possible solutions

Many thrifts have turned to the adjustable-rate mortgage (ARM) for salvation. ARMs were virtually unknown in 1981, but by 1984 two-thirds of all new mortgages had adjustable rates. By mid-1986 this figure had fallen to 20 percent, but by the end of 1987 it had risen again to 60 percent. Some thrifts now refuse to issue fixed-rate mortgages.

ARMs are certainly a valuable product in the home-mortgage market, but they are no panacea for the thrifts. Although they reduce interest-rate risk, they by no means eliminate it; the indices on which they are based are imperfect, and their rate adjustment is subject to annual and lifetime caps. In addition, ARMs involve a good deal more credit risk than fixed-rate mortgages. If monthly payments suddenly increase, many borrowers are likely to default; if monthly payments are held constant, the balance of the loan can grow, possibly above the home's value as collateral.

But the fundamental issue is the market-banking problem. If a perfect ARM—carrying no interest-rate risk and no credit risk—were invented, it would also be perfectly profitless to hold. Its value would be bid up until its return approximated incremental deposit rates. Real ARMs yield profit because risk—mainly interest-rate risk—is still involved. They are less risky than fixed-rate mortgages, but they also yield lower returns than fixed-rate mortgages.

If ARMs are not the solution, what is? Politicians, particularly those who want to discredit the Reagan administration's emphasis on free markets, often blame the current mess on deregulation; this line appeals to many thrift executives who liked the good old days, and even to a few Wall Street analysts. If deregulation is the problem, then the solution must be reregulation.

That, however, would be an expensive mistake. In an era of volatile interest rates, the traditional game is bound to fail—and for almost everyone at the same time. Not deregulation but the volatility of interest rates is what has undermined the thrift business, or

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rather exposed a weakness that has always been present. Deregulation was an intelligent response to economic instability.

Reregulation would presumably involve reimposition of interest-rate ceilings and the further restriction of thrifts' ability to make commercial loans and other nonmortgage investments. Neither idea makes sense. Interest-rate ceilings suffer from the flaw common to all price controls: sooner or later, they are broken by market movements. Customers will desert institutions that do not offer competitive interest rates. Similarly, regulations that keep thrifts from taking credit risk force them to take more interest-rate risk.

But if thrifts take credit risk, how can we prevent the absurd trade in brokered ADC loans, the fraud, and the inside dealing that have compounded the original thrift crisis of 1980? The answer is twofold: close all insolvent thrifts, and put healthy thrifts under the same supervisory system as commercial banks.

The problem of insolvent thrifts

The most immediate issue in the thrift crisis is the existence of approximately 350 insolvent thrifts, which have been permitted to remain open and to keep growing like a cancer. Virtually all independent observers agree that the cheapest and wisest resolution of the problem is to liquidate the insolvent thrifts. Despite this consensus, few have actually been closed. Some have been "rescued"—recapitalized at great cost to the government—and the rest have simply continued their operations.

Leaving insolvent thrifts open is a costly way to delay the inevitable. If liabilities substantially exceed interest-earning assets, old operating losses are certain to be compounded by new ones. Insolvent thrifts, moreover, must bid aggressively for market deposits, artificially driving up deposit rates for all thrifts and banks.

Finally, when there is nothing left to lose, the insolvent and nearly insolvent thrifts take huge gambles on credit risk in the hope of making a comeback. Virtually all of these gambles have now failed, leaving the FSLIC with a problem far larger than it had at the start of the crisis. Jonathan Gray reports one extreme example of this phenomenon in his booklet *Financial Deregulation and the Savings and Loan Crisis*:

> American Diversified Savings, a California S&L, . . . had been a mere $11 million in size at June 30, 1983, and had grown to $800 million in the next 18 months. At liquidation its $1.3 billion in assets were worth less than 40 cents on the dollar or $509 million, with a total cost to FSLIC of $800 million.

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> This anecdote is tantamount to a news report that a drunken motorist has wiped out the entire city of Pittsburgh.
>
> A company with $11 million in assets lost $800 million. With perhaps $500,000 in equity, it destroyed $800 million of insured deposits, a kill ratio of 1,600 to 1. In terms of sheer destructive power, only the black hole in astrophysics would appear to be in the same league.

The majority of insolvent thrifts grew with brokered deposits and brokered ADC loans, not real customers. Consequently, most of them will not be purchased by healthy companies; the size of their problems dwarfs their intrinsic value. The only reason that they remain open is that liquidation requires cash. Depositors do not want promissory notes; they want their money back. But the FSLIC has no cash. Indeed, it is deeply insolvent itself.

To explain the cost and futility of the FSLIC's mad scramble to "resolve" problem cases in 1988 requires a brief digression. The first step in dealing with a failed bank or thrift is to revalue all assets and all liabilities at current market prices. The excess of liabilities over assets is the base cost of the bailout. But the initial cash outlay required to liquidate the institution exceeds the base cost, since it must cover all of the institution's liabilities. The difference between the initial cash outlay and the base cost is recovered by selling the institution's assets.

Rescuing and resuscitating a failed bank or thrift makes sense only if the cost of doing so is less than the base cost of liquidating it. This will be the case only if an outside bidder perceives so much franchise value that it will pay a premium of one sort or another to get hold of it. For example, when the Federal Deposit Insurance Corporation (FDIC) sold the First Republic Bank system to NCNB Corporation in July 1987, the cost to the FDIC was estimated at between $350 million and $580 million below base cost.

Thrifts, however, are such narrowly defined businesses that they typically lack strong franchise value. Indeed, potential buyers have been frightened away by negative trends in the industry and the FSLIC's own insolvency. To "move" these properties, the FSLIC in effect offered large premiums to potential buyers. The most significant premium offered was tax benefits. i.e., major reductions in the buyers' income taxes. (Tax benefits in thrift bailouts are complex, poorly understood by Congress and the public, and much larger than is commonly believed.)

One sure sign of trouble was the near-total absence of real financial institutions—i.e., those companies that might be expected to value the franchises most highly—among the buyers. Instead, the

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bidders were generally individuals and corporations looking for high and guaranteed rates of return, but with little interest in the banking business itself. Investors like these can also use their money for high-yield leveraged buyouts, so they are generally seeking a 30 to 40 percent compound rate of return. Since a substantial amount of the return that they get from buying failed thrifts comes from FSLIC payments, something akin to government debt is being sold at an extremely high rate of interest.

Indeed, when tax benefits are taken into account, the buyers of failed thrifts may have been given returns of 40 to 60 percent. Such thrift bailouts probably cost the government two or three times the base cost. They are neither efficient nor economical.

It would be far better to end the charade and use cash to close the insolvent thrifts before they devour even more taxpayer dollars. The greatest merit of the Bush administration's plan is that it will provide cash to do so.

The future of healthy thrifts

Healthy thrifts should be encouraged to become banks. Indeed, the many strong thrifts have long recognized that their business definition is too narrow, and they have worked hard to provide new services. Regulators and legislators have accommodated them with ever-broader authorization to move in this direction. Many S&Ls, in fact, have already adopted the name "bank," and have taken on the trappings of full-service commercial banks.

The Administration's program takes one important step in this direction by putting the FSLIC under FDIC management. The program's greatest weakness, however, is that it nonetheless perpetuates the distinction between banks and thrifts; indeed, it relies upon this distinction to fund interest payments on new bonds to be issued by the Resolution Funding Corporation. In doing so, the Administration's program works against the public interest by deliberately hindering a natural evolution that offers existing S&Ls their best chance for survival. Since the traditional thrift business is in an advanced state of decline, it is perverse for the government to force companies to stay in this business when market forces would pull the best of them out of it.

Yet that is what is happening. The notion that S&Ls are paying for their own bailout and banks are merely increasing payments to "their" FDIC is a convenient political fiction, but it has a real economic cost. By continuing to insist on a separate thrift industry, the government continues to underwrite a losing cause. As interest rates

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rise further, more thrifts will fail and the price to be paid by the public will continue to climb.

Why should the government attempt to maintain a separate thrift industry? What possible public interest is served by preventing healthy S&Ls from merging with banks and/or joining the FDIC? Nearly a third of the S&Ls could meet the FDIC's capital requirements today.

The fact is that the thrift business can no longer be justified as an industry separate from banking. Just as the worst S&Ls must be closed, so the best ones must enter the banking system and be governed by bank regulations.

Perhaps a thousand S&Ls will be left in the middle, not bad enough to be liquidated and not good enough to meet FDIC standards. The main job of the FHLB system in the coming decade should be to manage this middle group, working with each S&L either to liquidate it or to help it become a bank.

Over time, the thrift crisis can be resolved. Resolution will be expensive, but the expense only grows the longer it is delayed. Thrifts helped house America, but times have changed. Rather than cling to the failed patterns of the past, we must move ahead. The destiny of healthy thrifts is to become banks; the destiny of insolvent thrifts is to be liquidated.

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