US savings associations stage a recovery

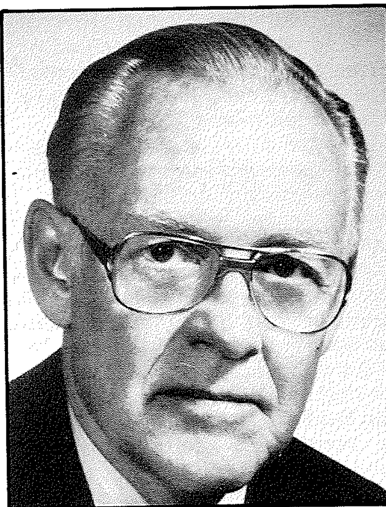
Although failures continue among savings institutions in the United States, many are notching up record earnings, as Norman Strunk explains.

IN recent years the savings and loan story in the United States has been a "good news — bad news" story. It continues to be so. 1985 was a year of substantial recovery in the earnings of America's savings and loan associations, with a record net income of $3,970 million, 0.39% of total assets. Earnings this year are expected to be well above the 1985 record, with many associations doubling last year's figures.

The bad news is that the business is currently looking at losses that will result from the failures of institutions — estimated to be in the range $12,000-18,000 million — which will have to be borne by the savings and loan system itself by way of extra, or special, annual contribution to the Federal Savings and Loan Insurance Corporation (FSLIC) and the virtual depleting of the "free" reserves of the Federal Home Loan Banks which, in turn, are owned by the savings and loan institutions.

The savings and loan industry

The savings and loan system in the United States currently comprises some 3,250 institutions with resources of $1,000 billion. Approximately one-third of the institutions are in capital stock form, and the other two-thirds mutual. Half of the 300 largest are of the stock type. A high percentage of the large institutions have converted to stock form since 1981, and practically all of the new institutions chartered in the past decade have been of the stock form.



The institutions are chartered and operate under an authorising law, either of the state in which their offices are domiciled, or of the federal government. Except for a small number of multi-state organisations, which have resulted from the merger of failed institutions, associations still operate from main and branch offices within their own state, although they may make and purchase loans beyond their own state borders.

The smaller institutions, of which there are many, essentially confine their savings and lending services to their own metropolitan areas. All the active savings and loan associations are members of the General Home Loan Bank System, which provides emergency and seasonal credit and long-term loans for on-lending. Virtually all institutions have their deposits insured by the FSLIC, a federal government instrumentality parallel to the Federal Deposit Insurance Corporation (FDIC), which insures deposits in commercial banks and the traditional savings banks. Some 70% of the assets of the savings and loans are invested in mortgages on residential property.

The earnings crisis and regulatory response

With the escalation of interest rates, which began in the late 1970s and became full-blown in 1981, these institutions suffered a severe earnings squeeze because of rising deposit interest costs, and the fact that practically all of their mortgages were written at fixed interest rates in earlier years.

In the mid-1970s, competition for deposit funds began to develop from a new group of unregulated financial intermediaries, known as money market funds, generally sponsored by security brokerage firms and by the large insurance companies. They offered the public the equivalent of a demand deposit with chequeing account privileges, at rates that were obtainable by the investment of funds in short-term money market instruments, primarily US Treasury and federal agency obligations.

The initial response to the problems these funds posed to the depository institutions was to permit thrift institutions and banks to offer so-

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called "money market certificates" of six-month maturity, with the rate being tied to the rate at the time on six-month obligations of the Treasury. This resulted in a massive flow of deposits from passbook accounts to the higher rate certificates.

Many institutions then found themselves in a position of paying out more for deposits than they earned on their assets. This disastrous earnings squeeze resulted in the depletion of the net worth of the business generally, and a virtual loss of the net worth and resulting insolvency of about a quarter of the institutions, including some which were large and highly regarded.

Once the minimum statutory reserve of 3% is penetrated, institutions in the US become subject to close federal supervisory scrutiny, and in many instances mergers are arranged. The number of associations fell rapidly from 4,613 at the end of 1980 to 3,244 at the end of 1985 as a result of failures and merging of institutions with weak net worth positions into stronger ones. It is interesting that during this same period of disappearance of institutions through failures or mergers there were some 300 new institutions chartered. These new institutions have not, of course, suffered the handicap of portfolios of low-rate, fixed-rate mortgages.

An Act of Congress, passed in 1980, granted permission to savings and loan institutions to issue interest-bearing chequeing accounts to individuals, and provided for the phasing out of the system controlling deposit interest rates known as Regulation Q. As of 31 March this year, the last vestiges of ceilings on deposit rates paid by banks and savings and loan associations have disappeared.

In 1982, Congress passed landmark legislation dealing with the savings and loan system — the Garn-St Germain Act — which provided for substantial deregulation. This permitted banks and savings and loan associations to compete on an even basis with the money market mutual funds, and to offer a wide variety of deposit and investment accounts in the acquisition of funds.

The Garn-St Germain Act also substantially broadened the range of assets in which federally chartered thrift institutions could invest. It permitted, for example, up to 40% of assets to be invested in mortgages on non-residential property, up to 30% of assets in consumer loans (which may be unsecured), commercial paper and commercial-type securities. It permitted another 10% of assets to be invested in secured or unsecured loans for commercial business purposes, ie loans typically made by commercial banks.

At the same time, state legislatures took parallel action, and in some important savings and loan states in growth areas, notably California, Texas, Florida and Arizona, the legal restrictions with respect to investment activities of thrift institutions were liberalised to a greater degree than were the federal associations by the Garn-St Germain Act.

In 1981 and 1982, the Federal Home Loan Bank Board eliminated many of the restrictions on loan-to-value ratios, limits on owner-occupied versus rental property loans, and repayment terms that had been carefully written into the regulatory rules in earlier years to prevent dangerous lending practices.

It should be noted that with the passage of the Garn-St Germain Act there is today no real legal distinction between savings banks and savings and loan associations in the United States. There are about 325 traditional savings banks, most of them located in the north-east section of the country.

In recent years, many savings and loan associations have changed their names to include the word "bank," but continue to be supervised by the Federal Home Loan Bank Board and their deposits insured by the FSLIC. They are generally still considered to be part of the savings and loan system. The data accompanying this article include all such institutions, but not those of the "traditional" savings banks.

One of the more constructive regulatory changes was the action of the Federal Home Loan Bank Board in 1981 to permit the widespread use of the adjustable, or variable, rate mortgages with only the restriction that the interest rate had to be tied to some published index.

After an initial period of uncertainty, the savings and loan associations began to make widespread use of this authority, and by 1984-85

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Earnings of Savings Institutions

Year	Portfolio Yield	Cost of Funds	Net Income (Millions) $	Return on Assets	Net Worth at End-Year $m
1975	7.71%	6.32%	1,448	0.47%	19,779
1976	8.00%	6.38%	2,250	0.63%	21,998
1977	8.26%	6.44%	3,198	0,77%	25,184
1978	8.50%	6.67%	3,918	0.82%	29,057
1979	8.86%	7.47%	3,620	0.67%	32,638
1980	9.34%	8.94%	784	0.13%	33,391
1981	9.91%	10.92%	−4,632	−0.73%	28,395
1982	10.68%	11.38%	−4,271	−0.65%	26,233
1983	11.17%	9.83%	1,968	0.27%	30,867
1984	11.66%	10.03%	1,101	0.12%	34,764
1985	11.53%	9.20%	3,970	0.39%	41,293

Source: Federal Home Loan Bank Board.

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some two-thirds of all mortgage originations were of the adjustable rate type. At the close of 1985, it was estimated that 46% of the residential mortgage portfolios of savings and loan associations comprised adjustable rate mortgages.

Recent years have been characterised by a strong real estate market, and until mid-1985 relatively high interest rates in the mortgage market. The result was a substantial improvement in the earnings of most institutions as they enjoyed high yields and origination fees on new loans made, plus a roll-off of the balances on the older, lower-rate mortgages.

New business and new problems

Most institutions moved carefully into broader investment and lending fields and, with some notable exceptions, have not only improved their income position but also the match of maturities between their assets and liabilities.

By early 1985, however, some problems came to the surface. Weaknesses began to appear in the federal supervisory system, particularly for savings and loan associations. With deregulation, both in deposit promotion and pricing and in asset management, there were simply not enough examiners, particularly examiners with experience, to monitor adequately the activities of the thousands of institutions.

There was high turnover among the top supervisory and legal people at the Federal Home Loan Bank Board. Further, the supervisory forces in a number of state governments, particularly those that substantially liberalised the powers of the institutions chartered under their laws, turned out to be completely inadequate.

Also in the period from 1981 through 1984, there had been a substantial turnover in the management of many savings and loan associations, and quite a few people came into ownership and management whose objectives were not consistent with the traditional objectives of the business, but who were primarily interested in short-term profits from the capital stock of the institutions, even if it meant taking enormous risks.

Further, many of the more traditional managers began to engage in more speculative lending as a way to improve earnings and to restore the net worth ratio of their institutions. In too many instances the results have been disastrous.

From 1980 through 1984, it is estimated that 270 institutions failed essentially as a result of a maturity mismatch, i.e. "earnings squeeze." Since 1980 there have been approximately 90 failures because of bad investments and operating practices, and another 200 to 300 institutions are in such a poor asset and net worth position as to suggest that they will not recover.

In the United States, institutions whose accounts are protected by deposit insurance do not fail in the classic sense, i.e. they are not closed or put into receivership and liquidated. Rather, to protect the deposits of savers and preserve their confidence, failed institutions have, with few exceptions, been merged with other institutions with capital assistance from the FSLIC (or FDIC in the case of a bank). In some instances, a failed savings and loan association has been sold to a commercial bank.

More recently, with fewer potential acquiring institutions and the danger of the depletion of the resources of the FSLIC facing the federal authorities, the FSLIC has followed the practice of dismissing the officers and directors of the failed institutions and placing management in the hands of a new board of directors, with executives borrowed from large, strong institutions. The FSLIC currently has some 40 of these "consignment cases" and more are expected.

Losses from failures due to poor investment practices and from institutions not expected to recover from the earnings squeeze are expected to be in the $12-$18 billion range. There are some estimates that these losses may be as high as $25 billion.

These potential losses should be compared with the total net worth of the savings and loan institutions of $41 billion at the end of 1985. However, 209 institutions with total assets of $260 billion had a net worth ratio of under 3%. Published net worth is the so-called regulatory net worth and includes intangibles and certain accounts not recognised under "generally accepted accounting principles" by the chartered, or "public," accountants.

New Deposit Flows and Loan Originations

Year	Net Deposit Flows $m	Loan Originations $m
1975	42,806	55,040
1976	50,585	78,776
1977	51,016	107,368
1978	44,864	110,294
1979	39,304	100,546
1980	42,094	72,537
1981	14,339	53,283
1982	39,774	54,298
1983	110,446	135,290
1984	106,828	172,234*
1985	47,627	180,017

**New series. All activity reported on a gross basis including refinancings and construction-Purchase loans.*
Source: Federal Home Loan Bank Board.

The assets of the FSLIC currently total $11 billion, of which about 60% represents real estate or defaulted loans acquired from failed institutions (which had been merged with other institutions), or investment in the net worth of institutions whose capital had been impaired but kept in operation.

Few people have been willing to go to Congress and the Treasury to ask for a contribution of federal, i.e. "taxpayer", funds to recapitalise the FSLIC and give it sufficient funds to meet its obligations to depositors. The result has been the development of legislation which is being considered by Congress that will provide for funds to be contributed by the insured institutions under a special assessment of 1/8 of 1% per year. This was initiated with effect from 1 January, 1985 and is in addition to the regular 1/12 of 1% regular annual insurance premium, that institutions pay to the FSLIC.

In addition, the reserves of the Federal Home Loan Banks, totalling $1.6 billion, are to be set aside into a new financing corporation which will leverage these funds by borrowings in the US capital markets to add to the resources of the FSLIC.

Reregulation

There is also a definite move to make sure that the mistakes of the past are not repeated. The federal examination staff has been substantially increased and higher salaries approved to permit the retention of competent people and the hiring of qualified accountants. The Federal Home Loan Bank Board has moved in the direction of reregulation — imposing limits on the extent to which FSLIC-insured institutions can engage in "direct investment" activities — investment in land, home building operations, etc., and in assets other than real estate mortgages, as permitted by the law for many of the state-chartered institutions. The Board, by regulation, had acted to slow down irresponsible growth and impose a higher standard of investment practices on the business. This contributed to a decline in net deposit from $107 billion in 1984 to $48 billion in 1985.

In addition, the Board is asking Congress to make certain amendments to the regulatory statutes so as to permit it to move more promptly in cases where bad management is apparent.

Share of the Market for Savings and Home Loans
Year-End 1985

	Total Savings Deposits Amount ($ Billions)	Total Savings Deposits % of Total	Total Home Mortgage Loans Amount ($ Billions)	Total Home Mortgage Loans % of Total
Savings Associations	752.3	30.6	430.9	33.8
Savings Banks	271.7	11.1	122.1	9.6
Commercial Banks	1,227.1	49.9	214.3	16.8
Life Insurance Cos.			13.5	1.1
Pension Funds			5.1	0.4
Money Market Funds	207.5	8.4		
Federal Agencies			490.6	38.4

The industry in context

The failing institutions syndrome is not confined to thrift institutions. There have been hundreds of failures in the commercial banking system, the most notable being that of the Continental Illinois National Bank and Trust Company in Chicago.

The dire conditions in the farm and energy economies have produced problems for commercial banks throughout the Midwest, particularly in Texas and Oklahoma. There is also concern about the loans of the large banks to third world nations which are recognised as "problem" loans, but which the banks have been able to avoid declaring in default and writing off.

The extra assessment that the insured savings and loan institutions are paying to the FSLIC has, to some extent, hindered the rebuilding of the tangible net worth of the business, but there is general optimism that most of the problems are behind it.

Through writing adjustable rate mortgages, the business has achieved a closer match in the maturities of its assets and liabilities. This programme has been retarded in recent months with many of the high interest and adjustable rate mortgages being refinanced by borrowers at today's lower interest rates, and usually on a fixed-rate basis. House buyers clearly prefer the fixed-rate mortgage, particularly at today's rates, and probably not more than a third of all savings and loan mortgage loan originations today are on a variable rate basis.

As one looks ahead, it is easy to see that the barriers to interstate branching are breaking down. the large and strong institutions are becoming, in effect, financial conglomerates with emphasis on residential real estate finance, which in the US remains a huge market. One can see a further decrease in the number of thrift institutions in the next five to 10 years, but most of the surviving institutions will still bear considerable resemblance to the savings and loan associations that were so successful until 1980. ■

Norman Strunk is secretary-general of the International Union of Building Societies and Savings Associations, a position he has held since 1980. From 1952 until 1980 he was the executive vice-president of the United States League of Savings Institutions. He remains affiliated to the United States League as senior counsellor. He currently serves on the boards of Great Western Financial Corporation, Talman-Home Federal Savings Association, Mortgage Guarantee Insurance Corporation, Federal Home Loan Bank of Chicago and the Liquidity Fund for Thrifts.