The crisis in the US thrift industry

By Mark Boléat

UNTIL recently American thrifts were similar in concept to building societies, with their primary functions being to collect retail deposits and to make mortgage loans to finance house purchase.

America does not have a nationwide banking system, but, rather, banks and other financial institutions are largely confined to operating at the state level, and many are regulated by state supervisory authorities rather than by federal authorities. The result has been a much more fragmented industry than is the case, for example, in the United Kingdom. At the end of 1985 there were over 3,000 individual thrifts.

In collecting retail deposits thrifts have been assisted by federal government guaranteeing of deposits, something introduced following the experience of the great depression in the 1930s which led to the collapse of many financial institutions. That insurance now covers deposits up to $100,000 and means that individual investors need have no concern about the soundness of individual institutions in which they place their money.

The traditional method of operation of the thrifts was to raise money through the short-term deposits, but make loans for long terms at fixed rates of interest. This does, of course, breach one of the cardinal principles of banking, that is, that institutions should match the maturities of their assets and liabilities. In practice, the thrifts were able to thrive while borrowing short and lending long, because throughout most of the 1950s, 1960s and 1970s, the long-term fixed rates at which they were able to lend were substantially above the short-term variable rates which they had to pay for their deposits. In addition, interest rates varied comparatively little.

IN THE United States, thrifts (or savings institutions, savings associations or savings and loans as they used to be called) are the largest specialist housing finance lenders. Traditionally, they operated by collecting deposits and making long-term fixed-interest loans. For nearly a decade now the thrift industry has been in crisis, caused initially by borrowing short and lending long, and more recently by a combination of unwise deregulation, lax supervision and sheer dishonesty and fraud. This article briefly describes how the situation has developed, and the steps being taken to deal with it.

The first crisis — the earnings squeeze

In the late 1970s and early 1980s interest rates became more volatile and the general level increased sharply, largely in response to inflation. These developments put the thrifts in a very difficult position. They were limited by regulation as to the rates of interest they could pay on deposits, and were forced to make loans at fixed rates of interest. Progressively, action was taken to deal with the liabilities side of the balance sheet with the thrifts being allowed to offer accounts carrying money market rates of interest.

However, while this solved the cash flow problem it worsened the earnings problem. The cost of liabilities had risen sharply in relation to the yield on assets, which could be increased only as existing low-rate mortgage loans were replaced by new higher-rate loans. The result was that the industry as a whole incurred a substantial deficit in 1981, and a further deficit in 1982. The average net worth ratio declined by a third in 1981 and 1982.

Many institutions ceased to exist, either by failing or through merging. Of the 4,002 institutions in existence at the end of 1980, no fewer than 843 had disappeared by the end of 1982. (Thrifts have subsequently been allowed to make adjustable rates loans, but even this power has often been misused, with unrealistically low pricing policies being adopted.)

The second crisis — unsound deregulation

The earnings crisis was accompanied by increasing competition in financial markets generally, as has been the case throughout the world. A general tendency has been for constraints on commercial banks to be removed, enabling them to compete more effectively in the mortgage market. Conversely, specialist housing finance institutions have been freed to diversify into related financial and housing services.

In the USA the combination of these two factors, together with the American political system which makes change very difficult, produced a new regulatory environment which, far from dealing with the

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problems caused by the earnings squeeze, made the problems very much worse.

The first response was the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. This provided for the phasing out of interest rate ceilings on various categories of deposit, increases in the powers of thrifts, and an increase in the ceiling for insured deposits from $40,000 to $100,000. In 1982 this was followed by the more far-reaching Garn/St. Germain Depository Institutions Act, which greatly expanded authority to invest in consumer, commercial and agricultural loans and other investments. It removed loan to valuation ratio limits and the restriction to lending on first mortgage, and it permitted investment in tangible personal property up to 10% of total assets.

This deregulation was fundamentally faulty, and the way it was introduced made disaster virtually certain. Perhaps the key to the current problems has been federal government guaranteeing of deposit accounts up to $100,000, meaning that neither individual investors, nor intermediaries need have any regard for the financial soundness of institutions with which they were investing. Even relatively new savings institutions found it possible to attract huge volumes of deposits through the broker market very quickly. Some of these deposits went to institutions which were being managed in an unsound way, and in some cases in a totally crooked way.

Given federal government guaranteeing of deposits, together with deregulation of activities, it is reasonable to assume that there should be much stricter supervision, paying regard in particular to the quality of management, the quality of assets, capital adequacy and so on. However, the opposite occurred. Indeed, there was competitive deregulation with some states deregulating their institutions much more than the federal authorities were prepared to do for federally chartered organisations.

This put the regulatory authorities in an impossible position. Thrifts were being freed, by law, to engage in a wide range of risky business, but their deposits were guaranteed by the federal government which was technically responsible for supervising them. Congress and the administration failed to give the supervisory authorities the staff or the powers they needed to deal with the new situation. As a result unsound practices were allowed to go undetected for long periods of time; even when they were detected often little could be done to stop them, and in any event by that time the damage had been done.

The nationalisation of housing finance

It is worth pausing here to consider the nature of the housing finance system that had been allowed to develop in the United States. While America may be seen as being the home of free enterprise, in effect what had been created was a nationalised housing finance system with both assets and liabilities being guaranteed by the government, and therefore in effect being government assets and liabilities. However, private sector institutions were responsible for making the assets and liabilities, and could benefit accordingly, but without suffering any risk.

On the liabilities side, the point has already been made that for most practical purposes, all deposits in thrifts were guaranteed by the federal government up to $100,000. Naturally, individual investors and intermediaries normally ensured that no one person had more than $100,000 invested in any institution, and where large sums of money were available for investment, these were split between a number of institutions. Neither individual investor, nor intermediary, needed to have any regard as to the safety of the institution with which they were investing, and indeed many continued to invest with institutions which were substantially insolvent, notably the largest thrift, American Savings, a subsidiary of Financial Corporation of America.

In effect investments were placed not with individual institutions, nor with the nominal insurance fund (the Federal Savings and Loan Insurance Corporation — FSLIC), but rather with the federal government itself, as it put the full faith in credit of the US government behind the insurance fund. Arguably the insurance fund has been an irrelevance and the fact that it has been wiped out has not prevented the government having to stand behind institutions. (Normally the reference is to the insurance of deposits, but as the government stood behind the insurance fund it is more proper to refer, as has been done in this article, to the government guaranteeing deposits.)

What has perhaps been less notable is the extent to which the federal government also dominates the assets side of the balance sheet. As institutions realised the dangers of borrowing short and lending long, so the secondary market agencies increasingly relieved them of the interest rate risk by buying their mortgages and selling mortgage-backed securities. This had a great deal of financial sense in it, as it enabled thrifts, which could not safely hold fixed-rate mortgages, to transform them into securities which could then be held by institutions, such as insurance companies and pension funds, better able to hold long-term fixed-rate assets in their portfolios.

However, the three principal secondary market agencies, the Government National Mortgage Association, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, not only did that, but effectively added a government guarantee as they transformed loans into securities. Institutional investors were therefore not purchasing mortgage-backed securities, but rather government-backed securities, and the only relevance of the mortgages was that they affected the repayment profile. This has now been formally recognised in the proposed capital adequacy requirements for different forms of security following the Group of 10 proposals. Mortgage loans will carry a 50% weighting, but mortgage securities backed by the government agencies will carry just a 20% weighting.

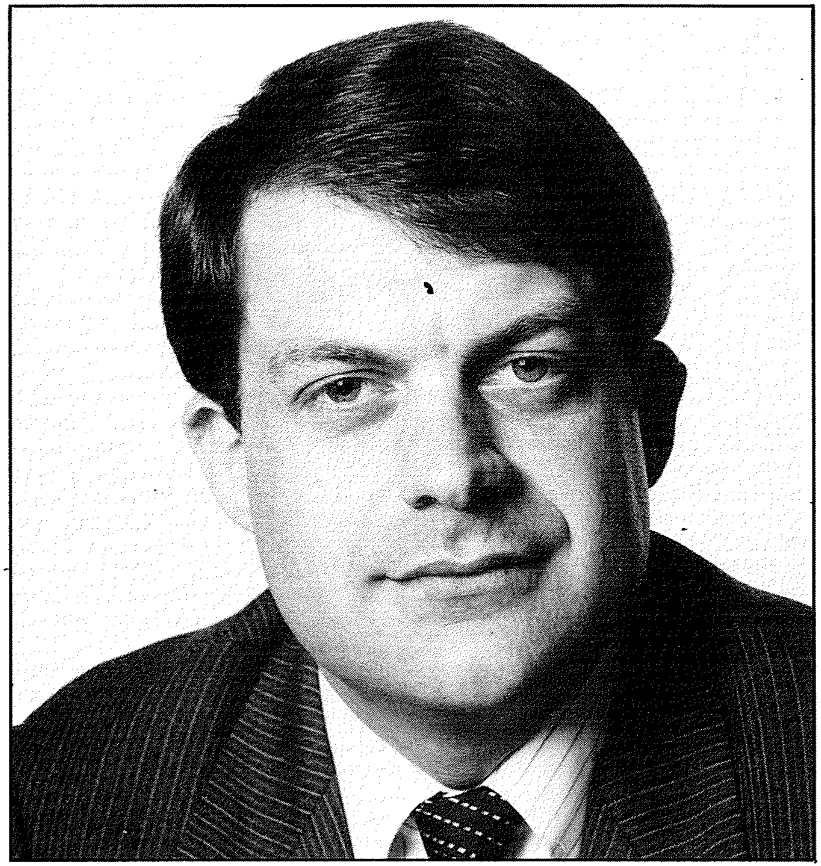
In addition to this, the government agencies themselves carry only minimal capital to back their contingent liabilities. Both the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association have contingent liabilities over 100 times their assets.

The effect of the government guarantee, plus the minimal capital actually held by the federal government agencies, has been to drive down the yield on mortgage-backed securities and, therefore, on the mortgages themselves from a level appropriate to mortgage loans to one more appropriate to government securities. This yield in turn has not been adequate for portfolio lenders. Opinions differ as to the extent of this effect, and generally it seems that the government secondary market agencies have driven down mortgage rates by, perhaps, 25 basis points, and given a very tight margin and a risky business, that is a very major impact.

The extent of the crisis

There are widely differing figures on the extent of the thrift crisis. This is because attempts to deal with the crisis have included various accounting devices, and also some of the solutions used so far have entailed tax breaks and other incentives which cannot be fully quantified, and which also have implications the full affects of which will not be known for a very long time.

However, there are some basic figures which show the extent of the crisis. Thrift collectively lost $7.8 billion in 1987 and $12.1 billion in 1988. 12% of savings institutions at the end of 1988 had no capital, and well over half had capital which fell short of what would be required of banks. Some 500 savings institutions, with total assets of $150 billion, were insolvent even allowing for the generous regulatory accounting practices, and a further 100 institutions with $300 billion of assets were insolvent if the generally accepted accounting principles are used.



Mark Boléat: Some 500 savings institutions were insolvent.

In 1988 alone, the cost of merging and selling insolvent institutions was some $28 billion, and at the end of the year the Federal Savings and Loan Insurance Corporation had a deficit of $27 billion.

The present best estimate is that over 10 years, dealing with the thrift problem will cost $126 billion, although a subsequent estimate, by the House of Representatives Banking Committee, has put the figure at well over $300 billion over 30 years.

That there was a major crisis was evident throughout most of 1988, but recognition of this was largely confined to the financial pages, and it seemed not to be taken seriously as a national problem. Certainly it did not feature in the Presidential election campaign. The issue has achieved much greater prominence as the new administration has taken office, and also as the extent of the problem has grown according to the official figures.

The first obvious question to ask is whether the government need do

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anything to deal with the crisis. There are some who argue that this is a crisis of the thrift industry, and there is no need for the federal government to take any action other than to let the bankrupt institutions go bankrupt. However, the existence of the federal government guarantee of deposits makes this not possible. If an institution was declared insolvent and closed down, then the government would immediately have to make up any shortfall, so as to allow depositors to be repaid in full. Moreover, if a large number of institutions were closed down simultaneously, particularly in parts of the country such as Texas where land values have been severely hit by the fall in oil prices, then the likely realisation of assets would be substantially less than their book value, and quite possibly less than could be realised over a period of years.

Put very simply, FSLIC has not been able to afford to close down insolvent institutions. Rather, it has had to seek ways of minimising the cost to itself and the government, and although this has meant closure of small institutions, in the case of larger ones, what has often been necessary is a merger into a larger group, or outright sale to a new institution, with a complicated financial package involving a capital input from FSLIC together with some guarantees and perhaps a share of any profits in the long term. This was done, for example, when the Robert Bass Group acquired Financial Corporation of America, the parent of the largest thrift with assets of over $30 billion. The cost to FSLIC of resolving this particular problem is estimated at $1·7 billion.

Reform

On 14 February, 1989, the Bush Administration outlined its proposals for reform, and these were followed by proposed legislation, entitled the Financial Institutions Reform, Recovery and Enforcement Act 1989 (FIRREA). It must be noted that merely because the government has proposed the legislation does not mean that the legislation will be enacted in anything like its present form. Already there are alternative plans, and past experience shows that the Administration has a very difficult task in persuading Congress to act on its recommendations.

The Act envisages the dissolution of FSLIC as a corporate entity. Its deposit insurance, conservatorship and receivership functions would be transferred to the equivalent corporation for banks, the Federal Deposit Insurance Corporation (FDIC). The FDIC will thus insure deposits of all insured financial institutions, but it will operate two separate funds, the Savings Insurance Fund (SAIF) for thrifts and the Bank Insurance Fund (BIF). The funds will not be merged and will be separately maintained.

Beginning with the fiscal year 1991 the Treasury will pay into SAIF a total of $32 billion over nine years. Where necessary the Treasury will pay any additional funds to ensure that SAIF has an adequate reserve ratio.

A new Federal Home Loan Bank System (FHLBS) would be created, to assume primary responsibility for the examination, safe and sound operation and regulation of savings institutions. The current independent three person Federal Home Loan Bank Board would be abolished and replaced by a single chairman of the new FHLBS who would be subject to the direction of the Secretary of the Treasury.

A Resolution Funding Corporation (RFC) will be created to provide funds to the Resolution Trust Corporation (RTC) which will manage and resolve supervisory institutions previously insured by the FSLIC. The RFC will be authorised to issue obligations not exceeding $50 billion, and to use the proceeds to purchase capital certificates issued by the RTC.

SAIF insured institutions will have to pay substantially higher insurance premiums than the BIF members. For 1990 the BIF members will pay 0.12% of deposits annually, and from the beginning of 1991 they will pay 0.15%. By contrast, thrifts are already paying 0.21%, and this will rise to 0.23% between 1991 and 1993 before falling back to 0.18% from the beginning of 1994.

The Act contains several provisions which would significantly limit the new activities of savings institutions:

(a) Whenever a thrift proposes to establish or control a company, or to conduct any new activity through a company it controls, it would be required to give the appropriate notice to the regulatory authorities, and to deduct from its capital its entire investment in the company.

(b) The asset growth of any thrift not in compliance with its capital requirements could be limited. Also the asset growth of any thrift taking excessive risk, or paying excessive rates for deposits, could be limited.

(c) The FHLBS would have authority to require a thrift to cease undertaking certain activities.

(d) The FDIC would have authority to promulgate regulations that would limit the ability of state chartered thrifts to engage in activities beyond those allowed for federally chartered institutions.

The Act requires that regulations for thrifts conform to specified requirements applicable to banks, including accounting standards and capital standards.

Generally, the big loser from this plan is the Federal Home Loan Bank Board which would lose most of its powers, and be placed under direct Treasury control. The main winner is the Federal Deposit Insurance Corporation which will take over the bankrupt FSLIC fund, and also take on responsibility for regulating thrifts.

One interesting point in the proposals is that the $50 billion of bonds intended to be raised by the Resolution Funding Corporation would not count in the federal budget, as they would not, strictly speaking, carry a government guarantee, although they would be regarded as government backed. This is likely to remain a controversial point.

A point of particular concern to thrifts is the requirements on capital adequacy. By June 1991, thrifts will have to meet the capital requirements applicable to FDIC insured banks, which means doubling their required capital ratio to about 6%. It is estimated that there are currently 1,300 thrifts only which satisfy the 6% level. If interest rates rise this figure could increase significantly.

The Economist, on 11 February, 1989, suggested that the unspoken goal of the Bush plan would be for the FDIC to force the weaker institutions into stronger hands, and the outcome would be a massive consolidation of what is now an absurdly fragmented industry. *The Economist* went on to say that the long-term effect of the plan, if implemented, would be the demise of a separate thrift industry in America.

There seems to be a general impression that what is being proposed, together with the crisis which the industry has experienced, will lead to the demise of a separate thrift industry, something which the industry is fighting against. Typical views were expressed in a leader in *The New York Times* on 20 February, 1989:

> "And who needs thrifts anyway? Even though neither the President nor Congress will raise the question publicly, it may be the most important of all. Thrifts were a special creation, to gather in local deposits and lend them out for local home mortgages. They held almost 60% of all mortgages 20 years ago; today they hold about a third. Unleashed by deregulation in the past decade, they spread their risks, often too far.
> Some managers gambled on windmill farms, casinos and other risky ventures; others bilked their institutions for personal gain. That's not reason enough to condemn the entire industry, but even the healthiest thrifts must share blame for fending off sane supervision that could have kept the problem from exploding.
> Thrifts' push into non-mortgage lending has narrowed the difference between thrifts and banks substantially. And new standards they must meet under supervision by the Federal Deposit Insurance Corporation — historically a strict bank regulator — will narrow it further. There are no longer compelling economic reasons for a separate thrift industry.
> Still, the thrifts have muscle on Capitol Hill, well toned by a constant flow of contributions to members of Congress, especially those on banking committees. It's now given that the industry's separate identity will be preserved.
> The President's immediate strategy is to plug the gushing losses and to impose closer supervision with every detail of his plan, but most of the objections are self-serving. S & Ls don't like losing a cosy relationship with regulators who didn't regulate; the FDIC is in charge now. And while banks and thrifts protest the higher insurance premiums ahead, politicians and public interest groups object to taxpayers footing half the bill.
> Mr Bush showed courage in coming to terms with the crisis so quickly; wisdom in offering a substantive plan, not a Band-Aid; and political savvy in spreading the pain. Let Congress now do the same."

'A failure of supervision'

The unique American position

It is, perhaps, tempting to extrapolate the American position to other countries. This would be misleading. There is virtually nothing in the American experience which has any relevance to any other industrialised country. The American experience was caused by a combination of circumstances unique to that country. The fragmented nature of the industry is perhaps an underlying cause, making supervision and sound banking practices more difficult to impose.

Government guaranteeing of deposits has undoubtedly been one of the major factors by allowing, and indeed encouraging, unsound thrifts to continue in operation. The transformation of mortgages into Government-backed bonds has, probably, also been a contributory factor.

However, the failure has essentially been one of supervision, and for this the authorities (widely defined) must take the blame. Here the position in America is quite unlike that in other countries. In most countries, there is a regulatory authority with considerable powers in respect of financial institutions. In America the Federal Home Loan Bank Board, and its off-shoot, the Federal Savings and Loan Insurance Corporation, have had responsibilities but inadequate powers. They have been forced to insure and to supervise institutions with powers granted by different authorities, the States, and have not been given the means to conduct that supervision.

The separation of powers, one of the fundamental principles of the American constitution, may have great advantages in terms of democracy, but in respect of the thrift industry a heavy price has had to be paid for this. ■

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