Savings & Loans in the US: Current Review & Future Prospects

By Michael Wilson

THE 1980s were a very turbulent period for savings and loans in the United States. Huge losses and negative publicity left the impression that the business was no longer viable. The fact is, however, that a strong and vibrant segment of the business does exist and will play a significant role in the financial markets of the future.

The savings and loan debacle in the U.S. has been well documented.[1] Record high interest rates and a deep recession severely weakened the business in the early 1980s. This was followed by a period of deregulation, lax supervision and an absence of any meaningful capital requirements. The seeds for disaster were sown during these years by a minority of savings institutions that engaged in rapid, uncapitalized growth in highly speculative investments.

Indeed, between 1980 and 1984, the business's assets grew 62%, from $604 billion to $978 billion. Its holdings of home mortgage assets (including mortgage-backed securities) fell from 70.9% to 56.0% of assets. The difference was made up by growth in higher risk ventures such as development and commercial real estate loans.

Meanwhile, the business's tangible capital declined 91%, from $32 billion to $3 billion. With a tangible capital-to-asset ratio of only 0.3% at the end of 1984 (compared with 5.3% at the end of 1980), the business, in the aggregate, was in desperate straits.

The system was pushed over the edge in the mid-1980s with the fall in world oil prices and regional economic difficulties. Whereas in the early 1980s the problems were caused by high interest rates - a largely self-correcting problem once rates declined - the difficulties now arose from poor asset quality and a lack of capital. Those were much deeper troubles with no obvious or low-cost solutions.

In the second half of the 1980s, the U.S. government undertook a number of initiatives aimed at stabilizing the situation[2]. None were very successful. It was not until early 1989, in the first weeks of the new Bush administration, that a comprehensive program was developed to deal with the hundreds of bankrupted institutions.

The legislation that passed—the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)—created a federal agency, the Resolution Trust Corporation, to deal with the problem. Although the funding for the RTC was inadequate and the organizational structure cumbersome, a vehicle was finally in place to resolve failed institutions.

But FIRREA went much further. It was labeled a "bailout" of the savings and loan industry. Although FIRREA actually protected depositors, the American public was under the impression that with their hard earned tax dollars, owners and managers of failed institutions were personally being assisted. As a result, FIRREA contained a number of punitive measures that were an expression of these national frustrations.

It was by no means clear in 1989 what would happen to the savings institutions business in the U.S. The majority of institutions were well operated, well capitalized and profitable. They had stuck to the traditional lines of business of home and personal financing. While they had no part in the debacle, they were painted with the same brush. They were guilty by association.

More than two years have passed, and it is fair to report that the savings institutions business is regaining its credibility. Although it has been roundly criticized, the RTC has taken over and closed hundreds of failed operations.

The healthy segment of the business that always existed is now more readily apparent. The thrift business in the U.S. in the future will be smaller but much healthier. It will be a vibrant component of the nation's

This article was especially commissioned for Housing Finance International. *Michael Wilson is Vice President and Director of Research, US League of Savings Institutions, Washington ,D.C.*

financial fabric. While many dangers are still present, the outlook for the business today is much more favorable than it was two or three years ago.

Tangible Capital Benchmark

One of the significant features of FIRREA is that it defined precisely the capital standards which savings institutions had to meet. It imposed a tangible capital requirement that will eventually equal 3%. Using this as a benchmark of solvency, it is possible to ascertain the extent of the excesses of the 1980s[3].

As shown in Exhibit 1, prior to the interest rate spike of 1981-82, virtually all savings and loans possessed at least 3% tangible capital. By 1984, however, the business had been so weakened that only 51% of all institutions had that much capital. Even more shocking is that these institutions accounted for only 30% of all assets.

Between 1984 and 1989, the condition of the business did get better. The absolute number and assets of institutions with more than 3% capital increased by 26% and 137%, respectively. These absolute changes can be attributed to institutions building capital ratios internally (through retained earnings and asset shrinkage) and externally (through the issuance of capital stock).

The share of the business that met the 3% threshold was helped by limited government actions which took care of some of the most severely troubled operations. But at the end of 1989, there were still 884 institutions holding $566 billion in assets that did not meet the 3% threshold.

1. Share of U.S. Savings & Loans with 3% or more tangible capital is the highest since 1980-81

Billions of Dollars

Year-end	Total savings & loans	Operating with 3% or more tangible capital	Percent of total savings & loans	Total assets	Operating with 3% or more tangible capital	Percent of total assets
1980	3,993	3,657	92%	$604	$560	93%
1981	3,751	2,937	78%	$640	$449	70%
1982	3,287	1,989	61%	$686	$249	36%
1983	3,146	1,752	56%	$814	$306	38%
1984	3,136	1,588	51%	$978	$289	30%
1985	3,246	1,815	56%	$1,070	$354	33%
1986	3,220	1,967	61%	$1,164	$472	41%
1987	3,147	2,004	64%	$1,251	$544	43%
1988	2,949	2,000	68%	$1,352	$614	45%
1989	2,878	1,994	69%	$1,252	$686	55%
1990	2,519	1,969	78%	$1,084	$678	63%
1991	2,409	1,950	81%	$1,002	$675	67%

Note: 1991 is as of June 30, 1991

Source: The Great Savings and Loan Debacle, James R. Barth (1980-89) and the Research Department, U.S. League of Savings Institutions (1990-91)

Since 1989, however, the situation has markedly improved. At the end of June 1991, 81% of all savings and loans holding 67% of all assets had reached the 3% tangible capital benchmark. Those are the highest percentages since 1980-81. Note, however, that neither the number nor the assets of institutions with 3% or more tangible capital has changed much since 1989. The reason that such a high percentage of the business now meets the 3% benchmark is that so many of the troubled institutions have been eliminated since 1989. That, in turn, can be attributed to RTC takeovers and resolutions.

RTC Activities

It is probably not an understatement to say that the RTC is the most politically unpopular government agency in the U.S. The reason is simple: It is charged with closing failed savings and loans that have large capital deficits and, as such, it has what seems to be an insatiable appetite for money. The U.S. Congress has provided the RTC with $155 billion to cover losses through April 1, 1992. Before the RTC completes its task, the price tag will probably top $200 billion.

In large part, the RTC is in a no-win situation. If it moves too fast to sell failed institutions, it will be accused of not recovering enough value from the assets it has taken over. On the other hand, if it moves too slowly, it will be accused of allowing the problem to grow.

Whole treatises have been written on the failures of the RTC and how it could go about its business more efficiently. Rehashing those is not within the scope of this article. Suffice it to say that the government has found it easy to take over failed institutions and sell their deposit bases to stronger organizations. The problem has been what to do with the assets.

The accomplishments of the RTC from its inception in August 1989 through Sep-

tember 1991 are depicted in Exhibit 2. Thus far, it has taken over 660 savings institutions. Of those, 563 have been closed. The rest are operating under the auspices of the RTC awaiting final resolution.

At the time of takeover, these 660 institutions had $344.1 billion in assets. Through sales, repayments, maturities and other adjustments, the RTC has shed assets totaling $196.7 billion, or 57% of what it initially acquired. The $147.4 billion in assets that it still holds ranks the RTC among the largest financial institutions in the U.S. today.

Not surprisingly, the RTC has had the most success selling securities (U.S. Treasuries, MBS, etc.), and the least success selling troubled real estate and subsidiary investments. The worst assets remain with the RTC, and that is one reason why few are sanguine about the ultimate cost of resolution.

"Healthy Core" Emerges

With all the attention the RTC attracts - as well as sensational courtroom trials of some notorious savings and loan executives, it is sometimes difficult to remember that there has always been a healthy core of savings institutions. The latest data released by the Office of Thrift Supervision (OTS), the chief federal regulator of savings and loans, clearly shows the existence of this solid core.

The OTS divides private sector thrifts - those not operating under RTC control - into four groups based on capital and profit levels. The first point to note from the data in Exhibit 3 is that not all the problems are in the past.

The OTS reported that it classified 79 institutions with assets of $63 billion as Group 4. These institutions are labeled as "expected transfers to the RTC." The RTC's case load will reach 739 institutions and $407 billion in assets once these

2. RTC has closed many S&Ls, but its holdings of unsold assets ranks it among the largest financial institutions in the U.S.

Billions of dollars.

Savings institutions closed by the RTC August 1989 through September 1991 = 563

	Total at takeover	Less asset reductions	Receivership assets Sep. 30, 1991	Remainder as a % of takeover
Cash & Securities	$72.1	$65.2	$6.9	10%
Mortgage loans	$131.4	$79.3	$52.1	40%
Other loans	$21.4	$13.8	$7.6	36%
Real estate owned	$21.1	$8.8	$12.3	58%
Subsidiary investments	$7.9	$1.3	$6.6	84%
Other assets	$15.7	$8.0	$7.7	49%
Total assets (gross)	$269.6	$176.4	$93.2	35%

Savings institutions operating under RTC conservatorship as of September 1991 = 97

	Total at takeover	Less asset reductions	Conservatorship assets Sep. 30, 1991	Remainder as a % of takeover
Cash & Securities	$26.4	$11.6	$14.8	56%
Mortgage loans	$31.8	$5.6	$26.2	82%
Other loans	$5.2	$1.9	$3.3	63%
Real estate owned	$6.2	($0.2)	$6.4	103%
Subsidiary investments	$1.9	$0.7	$1.2	63%
Other assets	$3.0	$0.7	$2.3	77%
Total assets (gross)	$74.5	$20.3	$54.2	73%

Totals for all 660 savings institutions resolved or controlled by the RTC August 1989 through September 1991

	Total at takeover	Less asset reductions	Held or controlled by RTC Sep. 30, 1991	Remainder as a % of takeover
Cash & Securities	$98.5	$76.8	$21.7	22%
Mortgage loans	$163.2	$84.9	$78.3	48%
Other loans	$26.6	$15.7	$10.9	41%
Real estate owned	$27.3	$8.6	$18.7	68%
Subsidiary investments	$9.8	$2.0	$7.8	80%
Other assets	$18.7	$8.7	$10.0	53%
Total assets (gross)	$344.1	$196.7	$147.4	43%

Note : Asset reductions include sales, payments and maturities and other adjustments.
Source : Resolution Trust Corporation

3. Healthiest Institutions represent three-fourths by number, Two-Thirds by assets
As of September 30,1991. Dollars in billions unless noted.

	Group 1	Group 2	Groups 1& 2	Group 3	Group 4	All private sector
Number	996	688	1,684	385	79	2,148
Percent of total	46.4%	32.0%	78.4%	17.9%	3.7%	100.0%
Assets	$306.6	$284.0	$590.6	$245.2	$63.0	$898.8
Percent of total	34.1%	31.6%	65.7%	27.3%	7.0%	100.0%
Tangible capital	$21.7	$14.7	$36.4	$6.6	($1.2)	$41.8
As a % of tangible assets	6.96%	5.16%	6.09%	2.74%	-1.97%	4.64%
Quarterly profits (same set of institutions: $ millions):						
Jul-Sep 1990	$521	$254	$775	($262)	($193)	$320
Oct-Dec 1990	$462	$156	$618	($548)	($425)	($355)
Jan-Mar 1991	$566	$427	$993	$11	($265)	$739
Apr-Jun 1991	$618	$458	$1,076	($220)	($479)	$377
Jul-Sep 1991	$602	$346	$948	($73)	($603)	$272
For Jul-Sep 1991 period :						
Percent of thrifts	97%	86%	93%	65%	43%	86%
Return on assets	0.79%	0.49%	0.65%	-0.12%	-3.74%	0.12%
Return on tangible capital	11.10%	9.41%	10.42%	-4.42%	NA	2.60%
Noncurrent loans & REO to total assets	1.54%	3.77%	2.61%	4.68%	9.52%	3.66%

Note: Group classifications--Group 1: Well capitalized and profitable; Group 2: Met or expected to meet capital requirements; Group 3: Troubled with poor earnings and low capital; Group 4: Expected transfers to the Resolutions Trust Corporation

Source: Office of Thrift Supervision

transfers are completed. On the upside, the OTS's Group 4 has shrunk by a significant degree. In December 1989 for example, Group 4 totaled 377 institutions with assets of $261 billion. The obvious transfers to the RTC are rapidly approaching an end.

Then there is the enigma of Group 3. The institutions in this group are so varied, that the OTS subdivides it into three categories. Of the 385 institutions in Group 3, 232 have average tangible capital of 4.59% and are losing money but at a slow rate. At the opposite extreme in Group 3 are 46 institutions with less than 1% tangible capital which are recording very large losses. In the middle is a set of 107 institutions with nearly 3% tangible capital but rather sizable losses.

Some of the Group 3 institutions will slide into Group 4 and from there to the RTC[4]. The condition of others will improve, and they will move up to Groups 1 and 2. Still others may languish in Group 3. These institutions might have a solid earnings base, but they have large problem asset portfolios. These institutions are not troubled enough to be taken over by the RTC—and if they were taken over, their value would decline immediately—but their prospects for advancement are not

favorable. The OTS is examining other means of dealing with these cases including government assisted mergers with healthy acquirers.

In discussing the future of the savings institutions business, however, the focus must be on Groups 1 and 2. These are strong institutions that are generally well capitalized and profitable. They will be the survivors.

Groups 1 and 2 consist of 1,684 institutions with assets of $590.6 billion. They boast an average ratio of tangible capital-to-tangible assets of 6.09%. They have recorded consistent profits, and they have been posting respectable returns on both assets and tangible capital. Of the four groups, they have the lowest level of troubled assets (noncurrent loans and repossessed real estate), the Achilles heel of financial institutions in the U.S.

It is interesting to note that the current assets of the healthy core are about equal to the 1980 level for the entire business. The healthy core of today's savings and loan business is only half as large as the entire business was at its peak in 1988, yet it has half again as much tangible capital. It is, without a doubt, a smaller but far healthier business.

Characteristics of the "Healthy Core"

Hints at what role these institutions will play in the future financial landscape of the U.S. can be gleaned from their present portfolios. They certainly have done quite well up to now. It is reasonable to assume, therefore, that they will continue to operate with a similar strategy in the future.

Exhibit 4 presents the portfolio composition for several types of depository institutions. Group 1 and 2 savings institutions have over 64% of their assets invested in home mortgages and MBS. Including their loans to individuals (auto loans, education loans, etc.), these solid thrifts have nearly 69% of their assets concentrated in household-oriented loans. Because of that fact, some savings institutions consider themselves to be family bankers.

The data in Exhibit 4 dispel the notion that all depository institutions are similar. That is partly true on the liability side of the balance sheet. For most institutions, deposits represent the primary source of asset funding, though commercial banks tend to have higher concentrations of demand deposits.

But it is on the asset side of the balance sheet that large differences remain. Compared to commercial banks, savings institutions have invested twice as heavily in household-oriented loans. While home mortgage investments of commercial banks are greater than those of savings institutions, home financing is still just a fraction of the total activity of the banking industry. It remains a predominantly commercial and security investor.

The real question is whether savings institutions can survive as household lenders, with the major emphasis on home lending.

Home mortgage lending does not expose lenders to a high degree of credit risk. The default rates on home mortgages are much lower than on other real estate and non-real estate loans. For all savings institutions at the end of September 1991, the delinquency rate for home mortgages was 1.5%; for other mortgages, 5.8%; and for non-mortgage loans, 2.4%.

On the other hand, interest rate risk is a more significant worry. After all, it was the concentration in long-term mortgages funded with short-term liabilities that devastated the business in the high and volatile interest rate period of the early 1980s.

Savings institutions, however, have made tremendous strides over the past decade in building buffers against interest rate fluctuations. Adjustable-rate mortgage loans now account for more than 50% of all home mortgage investments. In the early 1980s, ARMs were virtually non-existent.

In the current low rate environment, originating ARMs for investment is difficult. Homeowners are flocking to lock in low rate fixed-rate mortgages. While worrisome, savings institutions have other means of coping with the exposure to interest rate risk. They can concentrate on properly funding their mortgages. They can make loans for sale into the secondary market. Institutions also can avail themselves of various hedging techniques. Savings institutions are very aware of what transpired ten years ago, and they are not about to make the same mistake again.

The lack of product diversification also can be a concern. However, real estate markets in the U.S. are very localized. Prices and lending activity do not move in lockstep throughout the country. Thus, by holding a geographically diversified portfolio of home mortgages, savings institutions will, in fact, be investing in a variety of products.

With respect to diversification, it is important to acknowledge that while the healthy institutions in the aggregate are household lenders, there are pockets of institutions that have successfully diversified. Some have succeeded handsomely by becoming real estate venturers. Others have made their mark by becoming security investors. A small number have succeeded as financial supermarkets, offering their customers any and all services and products.

While these institutions are in a minority, the reasons for their success are no different than those for household lenders who have succeeded. Regardless of the business strategy, successful savings institutions are characterized by prudent

4. Healthy Savings Institutions tied to home and personal financial needs and they do not look like commerical banks

As of September 30,1991.

	Private sector savings institutions		Other depository institutions		
				BIF-insured	RTC
Billions of dollars	Groups 1 & 2	Groups 3 & 4	Commercial banks	savings banks	conserva-torships
Home mortgages and MBS	$379.6	$167.1	$685.6	$117.7	$19.2
Loans to individuals	$25.5	$15.1	$386.1	$8.8	$1.9
Subtotal: Total household loans	$405.1	$182.2	$1,071.8	$126.5	$21.1
Other real estate investments	$74.6	$67.1	$473.4	$51.2	$18.5
Other non-real estate loans	$11.4	$5.6	$827.5	$9.0	$1.5
Other assets (incl. cash & sec.)	$99.5	$53.3	$1,060.5	$50.7	$9.2
Total assets (net)	$590.6	$308.2	$3,433.2	$237.3	$50.3
Deposits	$479.2	$229.6	$2,665.8	$198.1	$40.6
Borrowings & other liabilities	$70.5	$67.0	$536.9	$22.9	$14.2
Equity capital	$40.9	$11.6	$230.5	$16.3	($4.5)
Total Liabilities & equity	$590.6	$308.2	$3,433.2	$237.3	$50.3
Percent of assets					
Home mortgages and MBS	64.3%	54.2%	20.0%	49.6%	38.2%
Loans to individuals	4.3%	4.9%	11.2%	3.7%	3.8%
Sub total: Total household loans	68.6%	59.1%	31.2%	53.3%	41.9%
Other real estate investments	12.6%	21.8%	13.8%	21.6%	36.8%
Other non-real estate loans	1.9%	1.8%	24.1%	3.8%	3.0%
Other assets (incl. cash & sec.)	16.8%	17.3%	30.9%	21.4%	18.3%
Total assets (net)	100.0%	100.0%	100.0%	100.0%	100.0%
Deposits	81.1%	74.5%	77.6%	83.5%	80.7%
Borrowings & other liabilities	11.9%	21.7%	15.6%	9.7%	28.2%
Equity capital	6.9%	3.8%	6.7%	6.9%	-8.9%
Total liabilities & equity	100.0%	100.0%	100.0%	100.0%	100.0%

Note: For group definitons see Exhibit 3. Loans to individuals for BIF-insured savings banks estimated from June 30, 1991 data.

Source: U.S. League of Savings Institutions using December 1991 press releases from the Office of Thrift Supervision, Federal Deposit Insurance Corporation and the Resolution Trust Corporation.

investments, solid underwriting standards and tight operating expense control.

Of course, the picture is not entirely bright even for home mortgage lenders. One concern is the ongoing federalization of the mortgage market. Mortgage pricing is dominated by the two government-sponsored mortgage agencies, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Between them, they hold or guarantee one out of every three conventional home mortgage loans.

To cope with this competition, savings institutions can operate in the part of the mortgage market that does not conform to the standards for sale to these agencies[5]. But that portion is not large and has been shrinking. Various estimates peg the non-conforming jumbo loan market at between 10% and 30% nationwide.

Another danger is that savings institutions will be tapped even more than they have been to help fund the resolution of failed institutions. The business is already paying a deposit insurance premium equal to 0.23% of total deposits. In 1984, the rate was only a third as large. There is discussion about raising the rate to as much as 0.30% in 1992.

These are political risks that can only be managed by active participation in the political process in Washington, D.C. While the business is not being embraced with open arms on Capitol Hill, it is finding a warmer reception today than it did in 1989. Indeed, the business did achieve some successes in the trimmed down banking bill that was passed by the U.S. Congress in November 1991.

In the final analysis, however, the marketplace will determine the future of the savings institutions. If they provide a valuable service, they will survive.

A lender specializing in home mortgage lending is not critical to the smooth functioning of the mortgage market. Savings institutions now account for only 20% of mortgage originations, compared with 50% just a few years ago. The secondary mortgage market has integrated home financing into the broader capital markets. It has brought in new investors. The massive presence of he government agencies ensures a steady supply of funds.

But specialized portfolio lenders can still fulfill a very real need and that is service to the customer. They can craft a mortgage product that will satisfy an individual customer's requirements. A customer can resolve a problem face-to-face instead of through a computerized telephone service.

Whether the savings institutions business survives as a separate entity is not really an issue. Some argue that a business that is one-fifth as large as the commercial banking industry cannot support its own regulatory apparatus and insurance fund. On the other hand, credit unions, with less than half the assets of healthy savings institutions, manage to do just that.

It does not matter what these institutions are called. Perhaps they will be folded into the banking industry. Perhaps there will exist a subset of commercial banks that will be dedicated to the household sector, just like there are banks dedicated to the agricultural sector.

The point is that there is a healthy and vigorous core of savings institutions operating more than 10,000 offices and providing full-time employment to over 160,000 people nationwide. Regardless of the appellation they are eventually given, these institutions have helped to weave the very fabric of this country as successful household lenders, and they are poised for continued success and growth in the future. ■

NOTES

[1] In this article, the terms "savings and loan," "thrift" and "savings institutions" refer to depository institutions insured by the Savings Association Insurance Fund (formerly the Federal Savings and Loan Insurance Corporation) and regulated by the Office of Thrift Supervision (formerly the Federal Home Loan Bank Board). There is another set of institutions referred to as "savings banks" that are insured by the Bank Insurance Fund and regulated, for the most part, by the Federal Deposit Insurance Corporation. Savings banks can be thought of as a cross between savings and loans and commercial banks.

[2] These initiatives included the management consignment program, $10.8 billion of funding provided in 1987 to the FSLIC, and a spate of deals in 1988 using yield maintenance and covered asset agreements and tax incentives.

[3] It was the lack of agreement on a capital standard that resulted in the widely varying estimates of the size of the savings and loan problem in the 1980s. Capital could be measured in a variety of ways, including regulatory, generally accepted, tangible and mark-to-market accounting principles.

[4] By virtue of legislation passed in November 1991, the OTS can transfer institutions to the RTC for resolution until September 30, 1993. The FIRREA deadline was August 9, 1992.

[5] In 1992, the FNMA and the FHLMC cannot purchase loans in excess of $202,300. Loans above that figure are referred to as "jumbo loans." This amount is adjusted each year to a index of home prices. Loans for sale also must meet certain underwriting standards. These include the ratio of housing expense to household income and the condition of the underlying collateral.