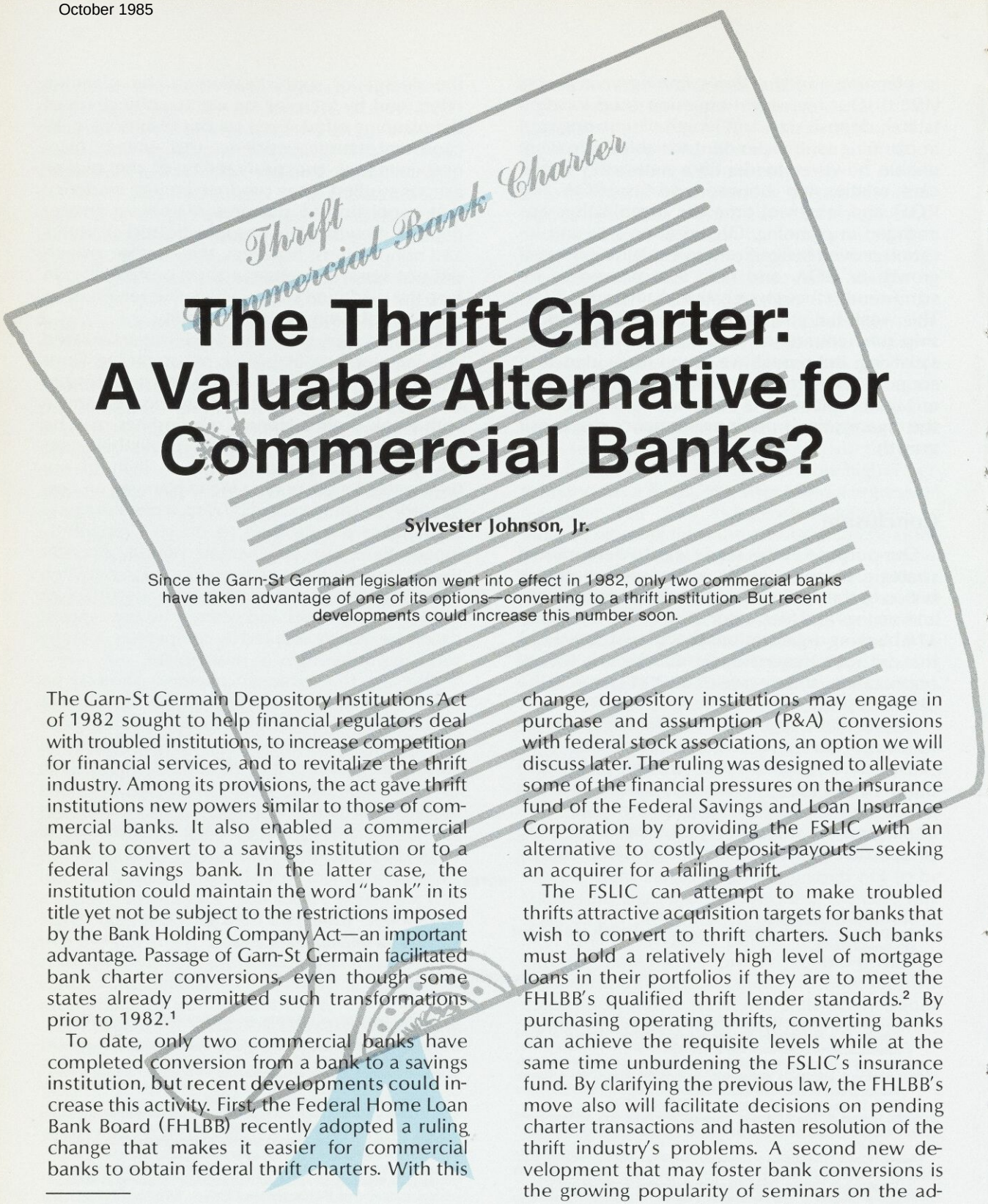

The Thrift Charter: A Valuable Alternative for Commercial Banks?

Sylvester Johnson, Jr.

Since the Garn-St Germain legislation went into effect in 1982, only two commercial banks have taken advantage of one of its options—converting to a thrift institution. But recent developments could increase this number soon.

The Garn-St Germain Depository Institutions Act of 1982 sought to help financial regulators deal with troubled institutions, to increase competition for financial services, and to revitalize the thrift industry. Among its provisions, the act gave thrift institutions new powers similar to those of commercial banks. It also enabled a commercial bank to convert to a savings institution or to a federal savings bank. In the latter case, the institution could maintain the word "bank" in its title yet not be subject to the restrictions imposed by the Bank Holding Company Act—an important advantage. Passage of Garn-St Germain facilitated bank charter conversions, even though some states already permitted such transformations prior to 1982.[1]

To date, only two commercial banks have completed conversion from a bank to a savings institution, but recent developments could increase this activity. First, the Federal Home Loan Bank Board (FHLBB) recently adopted a ruling change that makes it easier for commercial banks to obtain federal thrift charters. With this change, depository institutions may engage in purchase and assumption (P&A) conversions with federal stock associations, an option we will discuss later. The ruling was designed to alleviate some of the financial pressures on the insurance fund of the Federal Savings and Loan Insurance Corporation by providing the FSLIC with an alternative to costly deposit-payouts—seeking an acquirer for a failing thrift.

The FSLIC can attempt to make troubled thrifts attractive acquisition targets for banks that wish to convert to thrift charters. Such banks must hold a relatively high level of mortgage loans in their portfolios if they are to meet the FHLBB's qualified thrift lender standards.[2] By purchasing operating thrifts, converting banks can achieve the requisite levels while at the same time unburdening the FSLIC's insurance fund. By clarifying the previous law, the FHLBB's move also will facilitate decisions on pending charter transactions and hasten resolution of the thrift industry's problems. A second new development that may foster bank conversions is the growing popularity of seminars on the advantages of becoming a thrift and the steps involved in doing so.[3]

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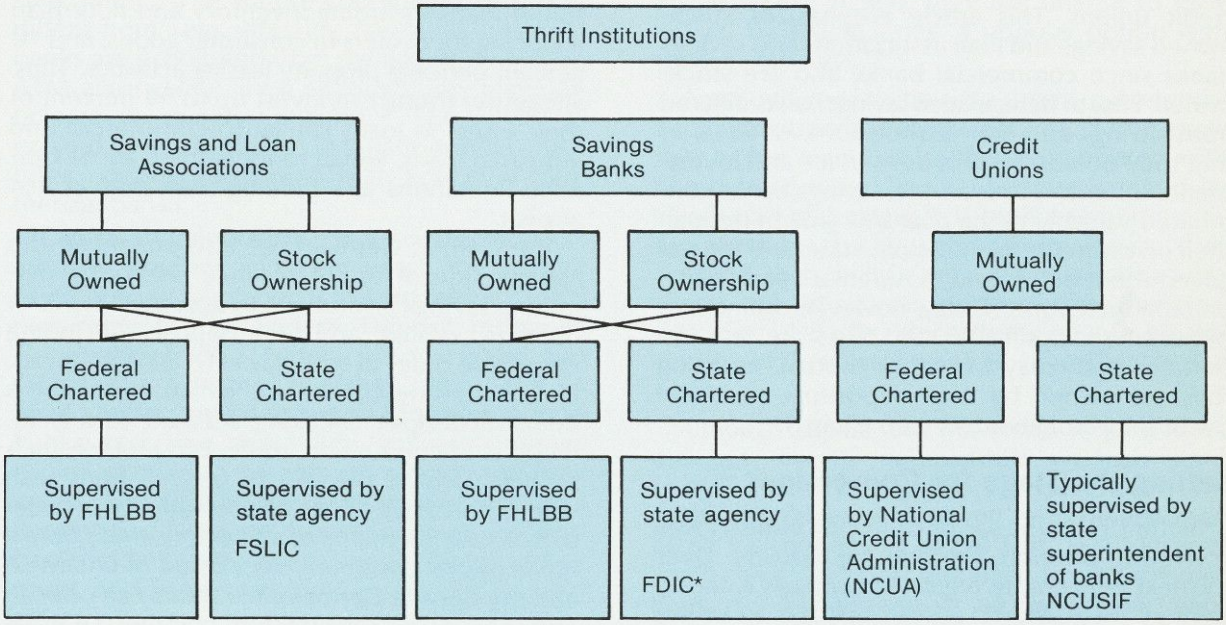
Chart 1. Thrift Industry Members



*Mutual savings banks are the only intermediaries cross-regulated by federal authorities serving commercial banks and savings associations.

Source: Federal Reserve Bank of Atlanta.

Weighing the pros and cons of thrift charters for commercial banks also highlights competition among regulators. According to William J. Brown, "one of the historic objectives of dual banking has been to provide alternative supervisory frameworks under which commercial banks may choose to operate, thereby safeguarding against the extension of harsh, oppressive, and discriminatory supervision to institutions without recourse to alternative arrangements."[4] The possibility of a commercial bank's converting to a federal savings institution places the FHLBB in direct competition for banks with bank regulatory agencies. Regardless of whether one views this situation as a "competition in laxity" in bank supervision, empowering banks to adopt thrift charters eventually may force changes in bank regulation.

The Garn-St Germain legislation permitted conversions to help assure financial stability, but in large numbers such activity would have a far wider, and perhaps unintentional, impact on the banking and thrift industries. For example, bank-to-thrift conversions would shift the balance of regulatory power, change required capital in depository institutions, and alter the mix of allowable activities for depository institutions.

We will discuss the pluses and minuses of bank-to-thrift conversions for both state and federal chartered institutions, examine current levels of conversion, and comment on the likelihood of a future wave of bank-to-thrift conversions. In the process, we will review thrifts' asset and liability powers and discuss what converting from a commercial bank to a savings institution entails.[5] Despite the obvious advantages of conversion—ability to own and operate interstate automated teller machines (ATMs), relaxed capital requirements, tax benefits—few have occurred and no substantial increase in activity is in sight. However, changes in public and regulatory policy can alter this trend.

In our discussion, we will use the term "thrift" interchangeably with "savings institution." Thrifts usually include savings and loan associations, which largely channel their deposits to the home mortgage market; both stock-owned and mutual

savings banks, which originally were founded to encourage thriftiness and provide a source of funds for workers with modest incomes; and credit unions. This article emphasizes stock-owned savings and loan associations and savings banks since commercial banks also are stock-owned. Prior to deregulation savings banks differed from savings and loan associations, or S&Ls, in that they possessed broader service and investment authority. For example, savings banks contributed valuably to the country's growth through their investments in municipal, state, and federal government bonds and in America's early transportation networks. Today, however, distinctions between savings banks and S&Ls are less important. Both may be either mutual, meaning they are owned by their depositors, or stock-owned, by stockholders (see Chart 1).

Setting the Stage for Conversions

In the 1930s, the savings and loan industry was revived to promote the housing industry. Over the next half-century, regulations virtually limited a savings institution's asset portfolio to home mortgages and U.S. government securities, while its liabilities consisted mainly of savings deposits. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) loosened these restrictions considerably by allowing federal savings institutions to invest up to 20 percent of their assets in consumer loans, commercial paper, and corporate debt securities.[6] It authorized mutual savings banks to make commercial, corporate, and business loans up to 5 percent of their assets. DIDMCA also established the Depository Institutions Deregulation Committee to supervise the phase-out of interest rate ceilings over a six-year transition period.

Enactment of the Garn-St Germain Depository Institutions Act of 1982 further expanded thrifts' powers. On the asset side, Garn-St Germain allowed thrifts to diversify their loan portfolios by extending commercial and similar loans. Unlike a commercial bank's unlimited commercial lending authority, however, a thrift's commercial loans could not exceed 10 percent of its assets. Although this restriction places thrifts at a comparative disadvantage, the limit can be circumvented since it applies only to a volume of loans outstanding at one time. Theoretically, a thrift could generate a virtually unlimited volume of loans if it sells off the excess to a third party, such as a nonfinancial subsidiary.[7] In addition, the entire loan portfolio, as a percentage of assets, could consist of 40 percent loans secured by non-residential real property, 30 percent consumer loans including inventory and floor-plan financing for dealers in consumer goods, and 10 percent personal property leasing activities. Thus, altogether thrifts can invest up to 90 percent of their assets in loans similar to commercial and industrial loans, which renders the Garn-St Germain limitations less binding than they at first appear.

The Garn-St Germain Act also enhanced the liability side of thrifts' balance sheets by permitting savings institutions to accept all types of demand, savings, and time deposits, including negotiable order of withdrawal (NOW) accounts. Unlike commercial banks, which can offer a demand deposit checking account to any individual or corporation, thrifts can provide such services only to persons or organizations with whom they have a loan relationship, or in order to facilitate payments to a business entity from a nonbusiness customer.[8] As a result of DIDMCA and the Garn-St Germain Act, thrifts can offer an array of services ranging from commercial loans to accepting demand deposit accounts.[9]

Pros and Cons of Thrift Charters

Currently, the thrift charter provides significant advantages over a commercial bank charter in some crucial areas—incentives that a commercial bank would consider when debating a charter conversion.

Branching. The McFadden Act, enacted in 1927, prohibits nationally chartered banks from branching across state lines. The Douglas Amendment to the Bank Holding Company Act allows holding companies to acquire institutions on an interstate basis if the target state passes legislation permitting out-of-state holding companies to acquire banks within its boundaries.[10] In contrast, no federal laws prohibit interstate branching of savings institutions. The FHLBB may authorize federally chartered thrifts to branch anywhere, intrastate or interstate, regardless of the headquarters states' restrictions on commercial banks or state chartered thrift institutions.

As a matter of self-imposed policy, the FHLBB has permitted federally chartered thrifts to establish branches across state lines only through an acquisition of a financially troubled thrift. However, if a thrift desires to operate interstate but is restricted by policy or the cost of expansion,

it can pursue the alternative of owning or operating ATMs and point-of-sale (POS) terminals across state lines.[11] The statute conferring this power differs from laws affecting banks, as national banks are prohibited from owning or renting an ATM across state lines, although they may participate in shared networks.[12] The ability to expand by establishing ATMs nationwide constitutes a distinct advantage thrifts hold over commercial banks.

Capital Requirements. As a consequence of industry troubles in recent years, the current trend in bank regulation is toward raising capital requirements. The Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, and Office of the Comptroller of the Currency (OCC) have similar capital standards for commercial banks, requiring that banks maintain primary capital of at least 5.5 percent of adjusted total assets.[13] In addition, the Federal Reserve Board's current guidelines for multinational and regional bank holding companies (BHCs) call for a minimum of 5.5 percent primary capital to total assets.

The weakened condition of the thrift industry has rendered it difficult for the FHLBB to raise the net worth requirements for savings associations by a significant amount, though it recently moved to tighten some requirements.[14] The FHLBB requires that all FSLIC-insured institutions maintain net worth, for regulatory purposes, equal to at least 3 percent of liabilities. In their first full fiscal year, newly established (de novo) institutions must maintain a minimum net worth level of 7 percent of liabilities; the requirement subsequently declines to 5 percent and may be reduced to 3 percent with proper approval. Thrift holding companies are not subject to regulatory net worth requirements.

A great disparity exists between the capital adequacy requirements for commercial banks and net worth requirements for thrift institutions.[15] Much of the difference results from the thrift industry's financial troubles over the past few years. During that period the net worth of many thrifts, especially older ones, deteriorated because their asset portfolios were dominated by long-term, low interest rate mortgages while their liabilities were affected by soaring interest rates.

Even prior to the 1980s, thrifts received somewhat more lenient capital treatment. One plausible explanation for this bias is the thrift industry's historically limited access to the capital markets. Since a large percentage of savings institutions are mutually owned, they are unable to raise capital by selling stock, a popular option with most companies.[16]

A second explanation for thrifts' preferential capital treatment involves loan risk. Some argue that higher loan loss levels are associated with commercial loans than with those secured by residential real estate.[17] If capital requirements are used to absorb shocks from losses, they contend, then thrifts' capital or net worth requirements should be less stringent than those for commercial banks, since thrifts have a greater portion of their asset portfolio in residential real estate.

Although capital and net worth requirements are not directly comparable, we can state overall that the regulatory requirements for FSLIC-insured institutions are more liberal than those for commercial banks. First, FSLIC-insured institutions are not required to reduce net worth by the amount of goodwill. Bank regulators generally require that intangibles, including goodwill, be subtracted from equity to obtain primary capital.

Another thrift advantage is the ability to amortize losses incurred in connection with the sale of mortgages over the average life of the mortgages sold. Banks generally are required to recognize such losses immediately.

A final comparative advantage is that financially troubled thrifts receive special capital treatment. At least until October 1985—Congress is considering an extension—the Garn-St Germain Act provides that thrift institutions beset by significant operating losses may use "net worth certificates" in meeting their net worth requirements. Troubled institutions may issue these certificates, which are purchased by the FSLIC and FDIC with promissory notes. The net worth certificates are then counted as part of the institution's net worth. Once the institution returns to profitability, it redeems its net worth certificates.

A capital-deficient bank considering conversion cannot use net worth certificates to bolster its position. However, once a bank converts to a thrift, the net worth certificate program—if extended in present form—would be an available option should the institution experience a net worth deficiency.

Old Stone Bank of Providence, Rhode Island illustrates how the differences in capital treatment can affect an institution. In 1983, the Federal Reserve Board's capital guidelines stood at 5 percent. Old Stone's capital amounted to only 3 percent of its assets, which made it an undercapitalized bank. However, when Old Stone exchanged its commercial bank charter for a thrift charter, it immediately met the FHLBB's requirement of 3 percent. In addition, since thrifts are not required to reduce net worth by the amount of goodwill, Old Stone Bank suddenly found itself capital-rich with a ratio of approximately 6 percent.[18]

Taxes. Depending on the structure of its portfolio, a savings institution may qualify for substantial tax benefits that were designed to encourage investment in the housing sector. Section 593 of the Internal Revenue Code (12 U.S.C. subsection 593) allows qualifying thrift institutions to deduct 40 percent of taxable income as an addition to reserves for bad debts. For an S&L to receive the full 40 percent deduction, at least 82 percent of its assets must be "qualifying assets," which include cash, taxable government obligations, and real residential property loans.[19] A savings bank, because of its slightly different regulatory history, can qualify for the full 40 percent deduction with only 72 percent of its assets meeting the code's definition of qualifying assets.

This tax advantage vis-a-vis alternative tax shelters may not be as significant to the thrift industry as it at first appears. For example, since 1980 savings institutions have had the power to hold general obligations of state governments. Although these instruments are classified as nonqualifying assets, thrifts, like commercial banks, can use them and other tax-exempt nonqualifying assets to shelter net income. This option achieves a result similar to holding the required percentage in qualifying assets.[20]

Nonbanking Activities. Two main concerns of law makers in separating banking and commerce were financial safety and efficient allocation of credit.[21] Some observers argue that further bank expansion into new activities will increase bank risk and threaten individual bank and financial system safety. In addition, a business entity directly linked with a commercial bank might receive favorable credit treatment from the bank, leading to reduced competition, artificial restriction of supply with possible price increases, and further misallocation of resources. In comparison, the thrift industry's traditional involvement in the housing industry and exclusion from commercial loans led to separate, more liberal treatment for savings and loan holding companies.

To maintain a separation between banking and commerce, section 4(c)(8) of the Bank Holding Company Act prohibits BHCs from engaging in activities too closely related to their primary banking functions. Similarly, multiple thrift holding companies are subject to regulatory limitations on their activities and ownership of other businesses. Federally chartered multiple thrift holding companies may invest in all types of personal property, for lease or sale, and through subsidiaries engage in real estate development and management, securities activities, life and casualty insurance agency operations, the ownership of other federally chartered thrift institutions, and other savings and loan-related functions.[22] If a holding company owns only one thrift (a unitary thrift holding company) and its federally insured institution meets the qualified institution standards, the parent company and its non-insured affiliates may undertake a virtually unlimited array of activities.[23] Examples of unitary thrift holding companies include Household International, ITT, National Steel, and Sears, Roebuck and Company. Unlike commercial banks, which must receive approval from the Federal Reserve on 4(c)(8) activities, unitary thrift holding companies require no approval process. However, if a unitary thrift holding company cannot meet the qualifications of a domestic savings and loan association, the firm and its affiliates become subject to the restrictions placed on multiple thrift holding companies.

Regulatory Considerations. Commercial banks may be regulated by the OCC, FDIC, Federal Reserve Board, and state banking departments. In contrast, federal thrift institutions generally have only one federal regulator, the FHLBB, and they are examined only by the FSLIC, which the FHLBB governs. (An exception occurs for thrifts that are insured by the FDIC.[24]) The FHLBB therefore possesses considerable regulatory flexibility since it maintains the supervisory, insuring, and lending processes under common control.

The thrift industry's special treatment does not always work to its advantage. First, much of

the industry's unique environment is the result of congressional legislation, which can be eradicated quickly, especially if additional federal revenues are needed.

Although thrifts enjoy some powers that are more liberal than powers for commercial banks, they must continue their commitment to housing finance and remain in compliance with other thrift regulations. This emphasis may be treacherous during periods of volatile interest rates. Floating rate mortgages and financial hedging instruments, such as financial futures and options, reduce interest rate risk, but their effectiveness is limited by consumer acceptance of the former and management's ability to exploit the latter. Compliance with other thrift regulations also requires management to juggle with skill such variables as loan limits, demand deposit restrictions, and tax considerations.

Final sources of relative disadvantage are the stability of the thrift industry and the FSLIC insurance fund, and the problems experienced recently by privately insured institutions. These problems, by reflecting poorly on the thrift industry as a whole, may diminish individual institutions' attraction for new customers.

Converting from Bank to Thrift Charters

Regulatory flexibility, favorable tax treatment, exemption from BHC Act prohibitions, and more lenient capital requirements may induce a commercial bank to surrender its charter in favor of a thrift charter. Although Garn-St Germain does not provide for the direct conversion of a commercial bank into a federally chartered thrift, it does authorize the de novo establishment of federal savings banks and the conversion of existing S&Ls to federal savings banks chartered by the FHLBB. Additionally, the act permits a savings bank to convert to an S&L.

A commercial bank wishing to convert to a federally chartered thrift may choose from three conversion methods: state law charter, purchase and assumption, and supervisory acquisition.[25] Where state law permits, a bank may convert to a state chartered stock thrift, which in turn can convert to a federal stock thrift.[26] In a purchase and assumption, or P&A, conversion, a bank forms a de novo federal stock thrift that purchases the assets and assumes the liabilities of the commercial bank. To effect a supervisory acquisition conversion, the commercial bank could acquire a failing mutual thrift through a voluntary supervisory conversion, convert to a stock-owned thrift, and purchase the assets and assume the liabilities of the commercial bank.

The FHLBB earlier this year acted to remove a regulatory impediment to its approval of P&A conversions. The board noted that subsection 552.13(c)(1) of the FHLBB regulations prevents a financial institution located in a state that does not allow state law charter conversion from converting to a federal thrift charter. The regulation specifies that a federal stock association may not purchase the assets and liabilities of any institution that is not insured by the FSLIC with the exception of a federal savings bank covered by FDIC insurance.[27] To encourage financially strong institutions to enter the thrift industry, and thereby to lighten the FSLIC's financial burden, the FHLBB resolved that even if the Home Owners' Loan Act of 1933 limits the entities with which a federal association may merge, the statute need not apply to reorganizations. (A reorganization denotes a bulk purchase of assets and assumption of liabilities where all or substantially all of one entity's assets are acquired by another.) After reexamining the issue, the FHLBB concluded that it possessed the authority to amend subsection 552.13 so that previously restricted institutions could engage in P&A conversions with federal thrifts. The FHLBB has limited bulk P&A transactions to depository institutions, whether insured by the FDIC, state, or private insurance funds. The ruling became effective on April 23 of this year.

The conversion process can be lengthy and difficult, as is exemplified by the case of Old Stone Bank. With supervisory assistance Old Stone Corporation, the holding company of Old Stone Bank, acquired Rhode Island Federal Savings and Loan Association, which then converted to a federal savings bank. As part of the transaction, the corporation received regulatory approval for the new federal savings bank to purchase all of Old Stone Bank's assets and assume its deposit liabilities. The conversion, completed in September 1984, required more than 18 months and involved seven regulatory agencies: the FHLBB, FSLIC, FDIC, Federal

Table 1. Commercial Banks Converting to Savings Institutions Since 1982

FHLBB District	Current Applications	Number of Approvals	Number of Disapprovals	Applications Withdrawn*
Atlanta	5	1	0	0
Boston	0	1	0	0
Chicago	0	0	0	0
Cincinnati	2	0	0	0
Dallas	0	0	0	0
Des Moines**	1	0	0	0
Indianapolis	2	0	0	0
New York	0	0	0	0
Pittsburgh	0	0	0	0
San Francisco	0	0	0	2
Seattle	0	0	0	1
Topeka	3	0	0	0
Totals	13	2	0	3

*Applications were withdrawn by commercial banks.
**Involves two commercial banks.
Source: Federal Home Loan district banks.

Reserve Board, Securities and Exchange Commission, and two state banking agencies. Although future conversions may be less convoluted than Old Stone's, they still are likely to be time-consuming.

Thirteen applications for conversion currently await FHLBB approval, but to date only two commercial banks have completed their conversion to thrift institutions (see Table 1). The first occurred in April 1984 when Southern Florida Bank, with assets of $31 million, received final approval to become a state chartered savings and loan association known as Southern Floridabanc Savings Association. The second instance was Old Stone Bank. Once Southern Floridabanc had become a state chartered S&L, it could have converted to a federal savings bank under the provisions of Garn-St Germain. However, Southern Floridabanc chose to retain its state charter because Florida-chartered thrifts are permitted to form subsidiary service corporations that can invest up to 10 percent of their assets or net worth, whichever is less, in businesses related to the thrift industry. Federal chartered thrifts can invest only 3 percent in service corporations. In most of the pending applications, commercial banks are seeking conversion to state chartered S&Ls primarily because state agencies tend to grant expanded powers to the institutions they charter.[28]

Recently, commercial banks have expressed greater interest in converting to thrift institutions. Apparently, the strongest incentive for conversion is the thrift industry's continued special treatment, notably relaxed capital requirements and branching privileges. This enticement becomes especially compelling when other regulatory agencies deny transactions that may be compatible with FHLBB policy. In addition, the array of services thrift institutions can offer may strengthen a commercial bank's position, enabling it to establish its share in a particular services market.

Obstacles to Conversion

Why have so few banks converted to a thrift charter? Clearly, conversion carries some benefits, which could be expected to generate conversion activity; however, no such boom is imminent.[29] Since the benefits have been discussed, we now look at the costs of conversion to explain the sluggish activity.

The transaction cost of conversion varies, depending on such factors as institution size, type of conversion, and legal costs. The cost of the new charter itself is relatively nominal while total legal fees are sizable. The opportunity cost of loss of service to customers seems not to apply, as both Southern Floridabanc and Old

Stone Bank accomplished their conversions without disrupting accounts or impairing major business units. A bank may incur sizable costs in time, however, as was the case in the complicated conversion of Old Stone Bank.

The cost of information may help account for the lack of conversion enthusiasm. Because the history of charter conversions is brief, banks considering such a move cannot weigh and learn from the combined experience of many other firms. Such banks may be the first to encounter particular problems in the conversion process, and so acquiring information to resolve those problems can be costly. Obtaining a federal charter allows the institution to use the term "bank" in its title, which may not be an inconsequential advantage. But some institutions elect to take state charters, even where federal and state chartered institutions have equal power.

The momentum of banking industry deregulation also may contribute to the slow growth of conversions, since the differences between commercial banks and thrifts continue to disappear.[30] Banks might judge it too expensive to alter their current asset structure in order to conform to thrift regulations if the benefits are only short-run.

The financial condition of the thrift industry may be retarding the pace of conversions. This decade's relatively high nominal interest rates in the United States have forced many savings institutions to close or merge with stronger entities.[31] The plight of institutions covered by private or state insurance, as well as the weakness of the FSLIC, compound the thrift industry's problems. Private and state insurance funds are vulnerable to a domino effect should a leading member institution encounter financial difficulties. The FHLBB recently noted that the FSLIC has incurred significant losses during the last four years, and said further "substantial losses and expenses" are likely in 1985.[32] The thrift industry's continued financial problems and consequent marketing concerns may deter some banks from entering the industry.

The misfortunes experienced by other thrifts, private insurance funds' troubles, or marketing considerations have induced some savings institutions to convert to commercial banks with FDIC insurance.[33] Most of these institutions were state chartered and privately insured; their actions were linked directly to the current private insurance fund crisis. Table 2 indicates that few federally chartered institutions have converted to commercial banks since 1982, but the persistence of thrift industry ailments may prompt more savings institutions to convert.

Table 2. Federal Savings Institutions Converting to Commercial Banks Since 1982

FHLBB District	Current Applications	Number of Conversions
Atlanta	0	1
Boston	0	0
Chicago	0	0
Cincinnati	0	0
Dallas	0	2
Des Moines	0	0
Indianapolis	0	0
New York	0	0
Pittsburgh	0	0
San Francisco	0	0
Seattle	0	0
Topeka	0	0
Totals	0	3

Source: Federal Home Loan district banks.

Regulations have restrained conversion activity further. In particular, the FHLBB's previous prohibition on P&A conversion transactions (unless the financial institution resided in a state permitting state law charter conversions) was a powerful brake. A small- or medium-sized bank in a state that prohibits commercial bank-to-thrift conversions may have lacked the funds to convert by acquiring a troubled thrift. The new FHLBB regulations should remedy this situation and encourage conversion activity.

New Thrift Charters

Owing to the expanded powers the FHLBB has accorded to thrifts, new institutions may be more likely to open as thrifts than as commercial banks. As a result, savings institutions could become more evident in the financial environment, especially if conversion activity accelerates.

Both new thrift institutions (FHLBB members) and commercial banks have grown in number, especially since 1982, but banks have increased

Table 3. New Member Savings Institutions and Commercial Banks, 1976 - 1984

Year	Total New Member Savings Institutions and Commercial Banks	Savings Institutions	Percentage Change	Commercial Banks*	Percentage Change
1976	205	44	21.46	161	78.54
1977	235	78	33.19	157	66.81
1978	198	50	25.25	148	74.75
1979	271	67	24.72	204	75.28
1980	314	109	34.71	205	65.29
1981	250	51	20.40	199	79.60
1982	363	46	12.67	317	87.33
1983	432	71	16.44	361	83.56
1984	543	88	16.21	455**	83.79

*Commercial banks are national banks, state member banks, and state nonmember banks.
**For comments on subsequent growth, see Paul S. Nadler, "Big Boom in New Banks," *Bankers Monthly Magazine*, vol. 102 (March 15, 1985), pp. 8-10.

Sources: Savings institution data are from the Federal Home Loan Bank Board. Most commercial bank data are from various issues of *FDIC Changes Among Operating Banks and Branches*; 1984 commercial bank data are from "Deregulation Spawns a Wealth of Small Banks," *The Wall Street Journal*, May 6, 1985.

more rapidly (see Table 3).[34] Their faster growth further emphasizes the apparent attractiveness of commercial bank charters even in the face of some thrift charter advantages.

Conclusion

Conversion to a savings institution, especially a federal savings bank, appears to be an attractive alternative for a commercial bank seeking to diversify or to lessen its regulatory burden. Conversion is particularly attractive for banks whose portfolios are more likely to meet the FHLBB's qualified thrift lender test. Incentives for banks to convert to savings institutions will continue as long as the thrift industry receives special legislative treatment and commercial banks are restricted from effectively competing with nonfinancial entities.

Policymakers must consider the possible unintended effects of the changes they mandate. Should Congress either extend the use of net worth certificates, assist the FSLIC, or offer further tax advantages to thrifts, for example, it may help the thrift industry but affect the rate of conversion. Policy changes that encourage more bank-to-thrift conversions, however, can further aid the thrift industry by allowing stronger institutions to enter. This opens up the additional possibility that healthy entrants will merge with weaker institutions, benefiting the FSLIC.

While there are arguments for encouraging bank-to-thrift conversion, policymakers should be alert to some potential pitfalls of a wave of conversions. In particular, policymakers should recognize the possibility that a wave of conversions might weaken the financial industry. For example, if all the converting institutions became subject to current regulatory net worth requirements for thrift institutions, it probably would diminish the capital to assets ratio for depository institutions. In addition to reducing the capital to assets ratio in depository institutions, a spate of conversions would transform the balance of regulatory power and increase the latitude of allowed activities for converting institutions. This phenomenon might also affect the soundness of financial institutions and the efficient allocation of credit. Significant changes in policy that could accelerate the number of conversions may need to be accompanied by changes in bank-to-thrift conversion policy to avoid an onrush of conversions.

So far, conversion activity is light. Despite their advantages, few conversions have occurred and no deluge is in sight. Conversion costs, information costs, transaction costs, and the cumbersome process itself probably dam the potential tide of bank-to-thrift conversions.

NOTES

[1]The *Federal Register* notes that the following states are believed to permit some type of conversion from a commercial bank to a savings institution: California, Connecticut, Florida, Maine, Missouri, Pennsylvania, Utah, Virginia, and Washington. When contacted, the state regulatory agencies for savings and loans for these states indicated that the possibility of conversion from a state-chartered bank to a state-chartered S&L has existed since the states began to charter S&Ls. See *Federal Register*, April 24, 1985, p. 16071.

[2]A qualified thrift lender is any insured institution that has an aggregate of not more than 25 percent of its assets (including loans made by any subsidiary) invested in commercial loans, nonresidential real estate loans, tangible personal property leased for commercial purposes, and floor-planning or inventory loans; or, has an aggregate of not less than 60 percent of its assets (including subsidiaries' investments) invested in loans, equity positions, or securities related to domestic residential real estate, or manufactured housing and property used by an institution in the conduct of its business. The institution must not fall below such percentage on an average basis in three out of every four quarters and two of every three years.

[3]For example, in 1985 Borod & Huggins conducted a seminar entitled "The Thrift Charter—Should You Convert Your Commercial Bank to a Thrift with a Unitary S&L Holding Company?"

[4]William J. Brown, *The Dual Banking System in the United States* (New York: American Bankers Association Department of Economics and Research, 1968), pp. 64-65.

[5]State-chartered institutions are regulated by agencies of the state government. Rules of operation are dependent upon the state of residency. They are subject to federal supervision only if they insure with the FDIC, or FSLIC, or NCUSIF, or affiliate with the Home Loan Bank System. Federally chartered S&Ls are regulated by the FHLBB and FSLIC. State and federal chartered institutions possess similar powers, which allows the institutions the opportunity to select the form that best fits its structure. At times the federal savings bank form is specified because it allows an institution to use "bank" in its title.

[6]For a fuller discussion of the new powers granted to savings institutions, both state and federal chartered, see Robert E. Goudreau, "S&L Use of New Powers: A Comparative Study of State- and Federal-Chartered Associations," *Economic Review*, Federal Reserve Bank of Atlanta, vol. 69 (October 1984), pp. 18-33.

[7]Some savings institutions appear willing to use this technique. For example, see comments of Theodore W. Barnes, chairman of Old State Bank in Alan Wade, "A National Financial Services Company," *United States Banker*, vol. 96 (March 1985), p. 31.

[8]It has been contended that a customer can maintain the demand deposit account even after the loan has been paid when the nature of the customer's business reasonably suggests a need for further loans. However, section 312 of Garn-St Germain is silent on this matter. See Thomas P. Vartanian and John D. Hawke Jr., "It Sounds Like a Banker's Fantasy, But It Isn't," *American Banker*, April 13, 1983. Also see Title III, Section 312 of the Garn-St Germain Depository Institutions Act of 1982.

[9]Although savings institutions can accept demand deposits and make commercial loans, they are not considered commercial banks. The Bank Holding Company Act defines a bank as an institution that both receives demand deposits and makes commercial loans, and so a savings institution might be classified as a commercial bank for some purposes. However, because section 333 of the Garn-St Germain Act excludes from the previous act's definition any institution that is either chartered by the FHLBB or insured by the FSLIC, savings institutions retain their distinction from commercial banks. Similarly, they are not treated as full competitors of commercial banks in most merger and acquisition analyses.

[10]For detailed discussions of interstate banking issues see "New Directions in Interstate Banking—Special Issue," *Economic Review*, Federal Reserve Bank of Atlanta, vol. 70 (January 1985) and "Interstate Banking Laws: Time to Remodel?—Special Issue," *Economic Review*, Federal Reserve Bank of Atlanta, vol. 70 (March 1985).

[11]See the FHLBB's policy on remote service units (RSUs) in FHLBB, *Annotated Manual of Statutes and Regulations*, Paragraph 931, subsection 545.141, 5th edition.

[12]A national bank is prohibited from owning or renting an ATM across state lines because such an action would be in violation of the McFadden Act. According to the comptroller's ruling in 1976, an ATM that is neither owned nor rented by a national bank is not deemed a branch of that national bank merely because that bank's customers may use the ATM in exchange for the payment by that bank of a transaction fee to the ATM-owner. Thus a national bank may participate in a shared electronic network. The Court of Appeals ruling on the Marine Midland case affirmed the comptroller's position.

[13]The federal banking regulatory agencies define primary capital as comprising common and perpetual preferred stock, surplus and undivided profits, contingency and other capital reserves, mandatory convertible instruments, 100 percent of funds set aside as reserve for possible loan losses, and minority interest in consolidated subsidiaries. Subtracted from the above categories are equity commitment notes and intangible assets. The FDIC and OCC subtract all intangible assets except for purchased mortgage servicing rights. The Federal Reserve subtracts only the goodwill portion of intangible assets. For a description of the above categories and information regarding new bank capital standards see R. Alton Gilbert, Courtenay C. Stone, and Michael E. Trebing, "The New Bank Capital Adequacy Standards," *Review*, Federal Reserve Bank of St. Louis, vol. 67 (May 1985), pp. 12-20.

[14]See, for example, "FHLBB Tightens Net Worth Rules Despite Opposition," *Savings Institutions*, vol. 106 (January 1985), pp. 6-8.

[15]Net worth is defined as the amount by which a savings institution's assets exceed its liabilities. It acts as a cushion to protect savers against any losses on loans and other investments, and consists of federal insurance and general reserves, paid-in surplus, undivided profits, subordinated debentures, appraised equity capital, net worth certificates, and mutual capital certificates for a mutual institution or permanent stock for a stock association.

[16]Although a number of savings associations have converted from mutual to stock ownership, many thrifts remain mutual institutions. For example, in its 1983 annual report the FHLBB notes that the number of FSLIC-insured institutions with stock form of organization increased from 755 at the end of 1982 to 780 at the end of 1983 as a result of conversions and new charters; over the same period, the number of FSLIC-insured mutual institutions declined from 2,594 to 2,403 because of conversions and mergers. See FHLBB, "Revitalizing America's Savings Institutions," *1983 Federal Home Loan Bank Board Annual Report* (Washington, 1984), p. 40.

[17]See Ira L. Tannenbaum, "Memorandum, re: Comparability in Thrift and Bank Regulation," *Golembe Reports*, no. 2 (March 5, 1984).

[18]"Why Some Banks Think It's Better to Be a Thrift," *Business Week*, November 19, 1984, p. 151.

[19]12 U.S.C. 770(a)(19)(c).

[20]See Herbert Baer, "Tax Barriers to Diversification by Savings and Loan Associations," in Federal Reserve Bank of Chicago, *Bank Structure and Competition*, Proceedings of a Conference held at Chicago, Illinois, May 1983, Conference Series, vol. 19 (May 1983), pp. 151-70.

[21]See Charles D. Salley, "1970 Bank Holding Company Amendments: What Is 'Closely Related to Banking'?" *Monthly Review*, Federal Reserve Bank of Atlanta, vol. 56 (June 1971), p. 100.

[22]A federally chartered S&L or federal savings bank can invest in real estate via a service corporation without a holding company structure. See FHLBB, *Annotated Manual of Statutes and Regulations*, paragraphs 1452-14526, fifth edition.

[23]The FHLBB defines a qualified institution as an insured institution, the business of which consists principally of acquiring the savings of the public and investing in loans. In addition, at least 60 percent of the institution's total assets at the close of its taxable year must consist of certain assets among which are cash, government obligations, loans secured by deposits, loans secured by residential real property, property acquired through liquidation of defaulted eligible loans, and property used by the institution in the conduct of its business. The subsection lists 10 categories of assets. For a complete listing see, FHLBB *Annotated Manual of Statutes and Regulations*, Paragraph 1452b, subsection 584.2-2, 5th edition.

[24]Converting state-chartered savings institutions may remain insured by the FDIC for a transition period.

[25]See Jeffrey C. Gerrish, "The Thrift Charter: Should You Convert Your Commercial Bank to a Thrift with a Unitary S&L Holding Company?" (Presented to the Sigma Foresight Meeting, Albuquerque, New Mexico, February 24-26, 1985), p. 28.

[26]In addition to the states mentioned in note 1, the *Federal Register* reports that the Idaho and Illinois statutes are silent on the matter and may permit such conversion. Michigan would allow commercial banks to convert to state-chartered thrifts if such a conversion is permissible under federal regulation. See *Federal Register*, April 24, 1985, p. 16071.

[27]Ibid, p. 16072.

[28]Investment in a service corporation is one of the most liberal powers that state agencies grant state-chartered thrifts. The three states with the highest limits on such investment are Florida, Texas, and California. State-chartered institutions in Florida may invest up to 10 percent of assets or net worth, whichever is less; in Texas the limit is 10 percent, and in California 100 percent. The additional investment privilege may enable a thrift to invest in more risky ventures.

[29]See, for example, Thomas P. Vartanian and John D. Hawke Jr., "Conversions May Spur Thrift Industry Rebirth," *American Banker*, April 14, 1983, and Carter Golembe, "Is There Really a Thrift Industry?" *Bottomline National Council of Savings Institutions*, no. 2 (February 1985), pp. 39-46.

[30]Gerrish (1985) and Tannenbaum (1984) seem to suggest this.

[31]As an indication, the 1983 Federal Home Loan Bank Board annual report states that the board approved 138 mergers in 1983, eliminating 159 institutions, whereas it had approved a record 425 mergers (involving 483

disappearing institutions) in 1982. Of the mergers approved in 1983, 23 were FSLIC-assisted, down from 44 in 1982; 31 were of a supervisory nature but without assistance, down from 166 in 1982; and 84 were voluntary, down from 215 in 1982.

[32] See "Bank Board Sets S&L Assessment," *American Banker*, February 25, 1985, and "Ohio S&L Crisis May Spur Industry," *Wall Street Journal*, April 8, 1985.

[33] Eight privately insured state-chartered savings institutions in Georgia have decided to convert to state-chartered banks covered by FDIC insurance. See Peter Mantius, "Privately Insured Georgia S&Ls Are Switching to FDIC," *Atlanta Constitution*, May 15, 1985. In addition, state savings and loan regulators in Ohio report that, since the recent crisis involving privately insured S&Ls, seven associations have converted to commercial banks. For comments on marketing considerations see "New Law Simplifies and Shortens Process for Converting State Banks to S&Ls and Thrifts to Banks," *American Banker*, June 25, 1985.

[34] In some expanding areas, Florida and Texas for example, the rate of growth of new state chartered thrifts during the first six months of 1984 has outpaced that of state chartered commercial banks. During that period the rate of state thrift openings has remained stable while that for federal charters has risen, but the rate of national bank openings has dropped. This could suggest that where growing real estate and consumer business exists, in addition to the increased denial rate of the OCC, thrift charters are attractive. See Mark Basch, "Rate of State Thrift Openings Stable, But Commerical Bank Start-Ups Fall," *American Banker*, August 22, 1985.