If thrifts that are poorly capitalized (i.e., those having less than 3 percent GAAP net worth) are included, the financially weak segment of the thrift industry rises to a total of 1,300 institutions, or 41 percent of all FSLIC-insured thrifts. The FHLBB reduced capital standards, first from 5 percent to 4 percent; then, in 1982, dropped it to the current level of 3 percent. As in the banking industry, there are also proposals under discussion to impose risk-based capital standards on the thrift industry.

There is a large segment of the thrift industry that requires capital injections to generate the long-term earnings needed to adequately rebuild capital. According to a recent United States General Accounting Office (GAO) report, the number of GAAP-insolvent institutions (i.e., those having less than 3 percent equity) has risen steadily since 1979.7 As of mid-1985, there were 461 GAAP-insolvent institutions with assets of approximately $113 billion, or 11 percent of total industry assets.

Thrifts have made significant strides to protect themselves. The duration of their assets today is shorter than it was during the 1981-82 recession. As a whole, however, they have taken limited advantage of new asset powers under the Garn-St. Germain Depository Institutions and Deregulation Act. Some observers are critical of the slow pace at which they are adjusting to their new powers. However, many thrifts apparently have adopted a moderate diversification pace because it allows them to become familiar with these powers more wisely and prudently.

Concluding Remarks

It is evident that a large segment of the thrift industry has only marginally benefited from lower interest rates since 1983. Using the GAO’s data, the financial condition of 471 thrifts, or 15 percent of the industry, has, in fact, worsened relative to the industry, as rates have fallen. It is still far from clear that marginally lower interest rates will eventually ease their financial problems.

There is even a larger thrift institution group whose long-run vulnerability depends on a sustained period of low interest rates in the future. This group comprises about 800 thrifts (26 percent of the industry) that are currently profitable, but that have negative or extremely low net worth under GAAP. These thrifts have made significant strides to protect themselves. The duration of their assets today is shorter than it was during the 1981-82 recession. As a whole, however, they have taken limited advantage of new asset powers under the Garn-St. Germain Depository Institutions and Deregulation Act. Some observers are critical of the slow pace at which they are adjusting to their new powers. However, many thrifts apparently have adopted a moderate diversification pace because it allows them to become familiar with these powers more wisely and prudently.

Setting Up Thrifts for a Crisis

The vulnerability of thrifts stems primarily from their historically narrow composition of assets and liabilities. Historically, thrifts specialized in offering savings deposits and mortgage loans. This special role was recognized in the 1930s with establishment of the FHLBB and the Federal Savings and Loan Insurance Corporation (FSLIC). During the 1960s and the 1970s, government policy encouraged thrift industry growth in an effort to provide a liquid source of home financing. This prose was mostly financed by the housing authorities, and regulatory restrictions on thrifts traditionally limited their acquisition of assets to low-duration mortgage loans and purchasing mortgage-backed securities.

The regulatory restrictions were reinforced by federal tax code provisions that offer thrifts a tax deferral on current income. As recently as 1980, thrifts were still affected strongly by these historic asset restrictions. At the end of 1980, for example, FSLIC-insured thrifts held more than 77 percent of their assets in residential mortgage loans and mortgage-backed securities. Commercial mortgages and consumer loans accounted for about 7 percent and 3 percent of their assets, respectively. Prior to 1980, thrifts were barred from the corporate lending market.

Thrifts also were handicapped because they traditionally relied on personal savings deposits that were subject to interest-rate ceilings.7 As of year-end 1980, for example, almost 79 percent of thrifts’ total liabilities were retail deposits. Approximately 60 percent of these liabilities were small-denomination certificates of deposit (CDs). Until the 1980s, few thrifts attempted to manage their liabilities actively, and most thrifts had only a small number of large-denomination (over $100,000) certificates of deposit, wholesale deposits, or wholesale agreements, and borrowed funds.

The Disintermediation Problem

The first major sign of thrifts’ vulnerability high interest rates was the disintermediation of deposits during the 1966 credit crunch, when they experienced the first substantial amount of deposit disintermediation.

During the 1981-82 recession, high interest rates sparked a financial crisis in the savings and loan (thrift) industry. A number of companies were liquidated; others required help from the Federal Home Loan Bank Board (FHLBB). Since then, the industry has shrunk from about 4,000 to 3,200 institutions.8 There is even a larger segment of the thrift industry that requires capital injections to generate the long-term earnings needed to adequately build capital. According to a recent United States General Accounting Office (GAO) report, the number of GAAP-insolvent institutions (i.e., those having less than 3 percent equity) has risen steadily since 1979. As of mid-1985, there were 461 GAAP-insolvent institutions with assets of approximately $113 billion, or 11 percent of total industry assets. The GAO study also found that low net worth is correlated with low profitability. Thus, we can infer that lower interest rates have not improved the earnings of the weakest segment of the industry on any sustainable basis.

Clearing the path was to buy time so that lower interest rates could repeat itself. The current return to fixed-rate lending by some thrifts, combined with the tendency to hold these instruments as portfolio loans, and to rely on short-term, variable-rate deposits for funding could provide all the ingredients for a case of deja vu. This could prove damaging because the duration mismatch is already self-correcting. Insolvent institutions could repeat their forced capital-depleted thrifts in a situation of paying out more than they take in—and when interest rates rise.

The Thrift Industry: Reconstruction in Progress

by Thomas M. Buyuk

This describes a phenomenon in which depositors shifted funds into higher-yielding investments when interest rates rose above rates that thrifts legally allowed to pay. In 1966, and again in 1969 and 1974, Treasury bill interest rates rose substantially above interest rates that thrifts could pay. As a result, depositors shifted funds from thrifts into higher-yielding instruments. Commercial banks also experienced fund-shifting, but they had more diversified sources of funds and could better weather deposit losses than thrifts. One effect of fund-shifting was a disruption in the flow of credit to mortgage markets. Mortgage rates rose rapidly, the FHLBB liberalized its regulatory accounting principles (RAP) in 1982 to avoid liquidity or providing financial assistance to a large number of problem cases. The purpose of RAP was to buy time so that lower interest rates could allow technologically insolvent thrifts to re-establish capital. There is growing criticism of RAP in some circles because RAP has been in place for four years, has not materially improved the condition of or outlook for thrifts, and merely conceals the true net worth of the thrift industry. The FHLBB has begun taking steps to repeal liberalized RAP rules, bringing them gradually in line with GAAP standards. Examples of this are the proposed FHLBB rule that would substantially limit the future use of deferred loan sharing, and the FHLBB insured thrifts.

The Federal Reserve Bank of Cleveland

Federal Reserve Bank of Cleveland Research Department

Box 6873, Cleveland, OH 44101

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Initial Adjustments in the 1970s and Early 1980s

Banking systems are among interest rate ceilings and because of more proficient liability management during the 1970s, thrifts were financing their asset limitations, thrifts were financing long-term, fixed-rate mortgages with rising, market-rate deposits. Thus, while MMCs prevented deposits, they greatly increased the cost of deposits relative to the average yield on their mortgage portfolio (see chart 1). This situation faces some thrifts today creates a “heads I win, tails the FSIC loses” situation. If its strategy is successful, a risk-taking strategy and its stockholders profit enormously. But, if unsuccessful, the FSIC sheds deposits and bears much of the loss. A major consequence of the 1980 de-regulation act is that the susceptibility of thrifts to fund-shifting has been higher. As a result of being offered to offer money market deposit accounts (MMDA) and Super NOWs, thrifts now can compete effectively for retail deposits.

In 1978 and 1979, thrifts were offering mortgages in the 9 percent to 10 percent range, while paying as much as 15 percent on their short-term, market-rate liabilities. Consequently, from 1980 through 1982, thrifts suffered severe losses (see chart 2). As high interest rates battered thrifts’ earnings, and as uncertainty grew over what interest rates would decline, some thrifts switched from low-yield, residential mortgage assets to higher yielding, but riskier, commercial mortgage assets. This strategy adds high-yielding assets at a rapid pace by purchasing high-cost wholesale or brokered deposits. Many insolvent or near-insolvent thrifts viewed this as a necessary tactic for near-term survival.

Riskier assets often provided these thrifts with high returns, but also contributed to large losses when market conditions became unfavorable. An insolvent thrift, or a thrift approaching insolvency, has the incentive to take chances to improve its position because FSIC deposit insurance.

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Chart 1 Selected Financials for FSIC Insured Institutions

<table>
<thead>
<tr>
<th>Year</th>
<th>Total net income</th>
<th>Net operating income</th>
<th>Net non-operating income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$10,000</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>1984</td>
<td>$11,000</td>
<td>$6,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>1985</td>
<td>$12,000</td>
<td>$7,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

SOURCE: Federal Home Loan Bank Board.

Deregulating Thrifts in the 1980s

As the financial health of the thrift industry deteriorated, Congress enacted the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980. The Depository Institutions Act of 1982, popularly known as the Garn-St Germain Act, followed. This act gave the Federal Home Loan Bank System the authority to authorize the 6-month money market certificate of deposit (MMC). The MMC required a $10,000 minimum deposit and its interest rate was tied to the 6-month Treasury bill rate. Arranged nationally, allowing depository institutions finally had a retail liability product that was competitive in a high-interest-rate environment. At that time, thrifts began replacing liabilities that had low ceiling rates, like the passbook savings account, with market-rate deposit instruments. The MMC was a key factor that reduced thrifts’ vulnerability to fund-shifting in the 1978-82 period as interest rates escalated into double digits. As high interest rates battered thrifts’ earnings, and as uncertainty grew over what interest rates would decline, some thrifts switched from low-yield, residential mortgage assets to higher yielding, but riskier, commercial mortgage assets. This strategy adds high-yielding assets at a rapid pace by purchasing high-cost wholesale or brokered deposits. Many insolvent or near-insolvent thrifts viewed this as a necessary tactic for near-term survival. Riskier assets often provided these thrifts with high returns, but also contributed to large losses when market conditions became unfavorable. An insolvent thrift, or a thrift approaching insolvency, has the incentive to take chances to improve its position because FSIC deposit insurance.

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Initial Adjustments in the 1970s and Early 1980s

Beginning in 1978, tightening of interest rate ceilings and because of more proficient liability management during the 1970s, thrifts became less vulnerable to fund-shifting in 1979-82 period as interest rates began rising rapidly in 1978, high yields enabled thrifts to avert the vulnerability to fund-shifting in 1979-82 period as interest rates began rising rapidly in 1978, high yields enabled thrifts to avert the fund-shifting problem and improved the profitability of their asset portfolios.

In June 1978, federal regulators authorized the 3-month money market certificate (MMC) suggesting that a $10,000 minimum deposit and its interest rate was tied to the 6-month Treasury bill rate. ARMs, and the availability of non-mortgage loans, including commercial loans, enabled thrifts to offer up to 30 percent of their total assets in non-mortgage loans, including consumer loans, commercial paper, and corporate securities. Federally chartered thrifts also were empowered to offer up to 30 percent of their assets in non-real estate commercial loans. In 1982, federal regulators liberalized the adjustable-rate mortgage (ARM) by providing thrifts with wider discretion over ARM terms and conditions. Armars provided the incentive to take chances to improve its position because thrifts can sell their ARM pools to hedge against interest rate risk, particularly if they retain their ARM pool.

The Acquisition of Commercial Loans

Since 1983, interest rates have declined, and thrift industry profits have softened considerably in recent months, owing to rising mortgage credit demand and greater stringency regulations that requires thrifts to hold reserve balances against poorly performing commercial loans.

Finally, the thrift industry was actively marketing ARMs instead of fixed-rate mortgage loans. Indeed, the ARM share of new loan originations grew rapidly in 1983, peaking at 68 percent in August 1984. According to FHLBB estimates, ARMs presently account for about one-third of the current value of all mortgage loans held by thrifts.

Fixed-rate mortgage rates have declined substantially since mid-1985. Borrowing costs have declined as a result of the declining short-term interest rates. Consequently, ARMs mainly become fixed-rate financing of new mortgages, and are refinancing existing mortgages that have high fixed or adjustable terms. Consequently, ARMs today constitute less than one-third of all new loans.

Mortgage banking techniques are becoming more common among thrifts as a method to protect themselves. The FHLBB broadened the ability of thrifts to use financial futures in 1981, when it eased regulations governing their use by thrifts. A financial futures or a forward contract permits thrifts to hedge interest rate risk, particularly if they retain fixed-rate assets in their portfolios.

The Capital Adequacy Problem

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If thrifts that are poorly capitalized (i.e., those having less than 3 percent GAAP net worth) are included, the financially weak segment of the thrift industry rises to a total of 1,300 institutions, or 41 percent of all FSLIC-insured thrifts.

As of June 1985, even weak thrifts had assets of almost $433 billion, or nearly 43 percent of total industry assets. The GAO study also found that low net worth is correlated with low profitability. Thus, we can infer that lower interest rates have not improved the earnings of the weakest segment of the industry on any sustainable basis.

Concluding Remarks

It is evident that a large segment of the thrift industry has only marginally benefited from lower interest rates since 1983. Using the GAO’s data, the financial condition of 471 thrifts, or 15 percent of the industry has, in fact, worsened. Indeed, the recovery has been slow, and it is still far from clear that marginally lower interest rates can eventually ease their financial problems.

There is even a larger thrift industry group whose long-term viability depends on a sustained period of low interest rates in the future. This group comprises about 800 thrifts (26 percent of the industry) that are currently profitable, but that have negative or extremely low net worth under GAAP.

Thrifts have made significant strides to protect themselves. The duration of their assets today is shorter than it was during the 1981-82 recession. As a whole, however, they have taken limited advantages of new asset powers under the Garn-St Germain Depository Institutions Act and the RAp (Rapid Asset Sale) Acts. Some observers are critical of the slow pace at which they are adjusting to their new powers. However, many thrifts apparently have adopted a moderate diversification pace because it allows them to become familiar with these powers more wisely and prudently.

Thrifts also are relying on ARMs and are adopting mortgage banking as a viable lending strategy. However, as a whole, they have made only slow progress toward portfolio immunization.

The industry is still vulnerable to rising and volatile interest rates because their asset portfolios are still dominated by long-term, fixed-rate mortgage loans. Some thrifts currently are even taking steps to avoid improving loss rates that could repeat itself. The current return to fixed-rate lending by some thrifts, coupled with their traditionally narrow interest-rate margin, creates a dilemma for investors who want to avoid fixed-rate mortgages. Indeed, history shows that high and volatile interest rates have caused for the past major hint of trouble back in 1966. We show that, despite deregulation of the lending and other asset powers of thrifts since 1980, must be done to reduce their susceptibility to high interest rates and to unfavorable economic conditions.

Setting Up Thrifts for a Crisis

The vulnerability of thrifts stems primarily from their traditionally narrow composition of assets and liabilities. Historically, thrifts specialized in offering savings deposits and mortgage loans. This special role was recognized in the 1930s with establishment of the Federal Home Loan Bank Board (FHLBB). Since then, the industry has shrunk from about 4,000 to 3,200 institutions.

There is a large segment of the thrift industry that is poorly capitalized. According to a recent U.S. General Accounting Office (GAO) report, the number of GAAP-insolvent institutions (i.e., those with negative GAAP net worth) has risen steadily since 1979.7 As of mid-1985, there were 461 GAAP-insolvent institutions with assets of approximately $113 billion, or 11 percent of total industry assets.

However, since the level of net worth is extremely low, a sustained period of low interest rates is still required so that strong earnings can sufficiently recapitalize the industry.

Thrifts, moreover, will have to consistently generate even higher earnings if the FHLBB adopts a proposal to raise capital requirements from 3 percent to 6 percent, which is the capital ratio for commercial banks. Since the 1966 establishment of the FHLBB reduced capital standards, first from 5 percent to 4 percent, then, in 1982, dropped it to the current level of 3 percent. As in the banking industry, there are also proposals under discussion to impose risk-based capital standards on the thrift industry.

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