October 1, 1988

ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

How Are the Ex-ODGF Thrifts Doing?

by Paul R. Watro

Not long ago, excessive deposit withdrawals caused a moratorium on privately insured thrifts (savings and loan associations) in Ohio.[1] On March 15, 1985, Governor Celeste closed all 70 state-chartered savings and loan associations insured by the Ohio Deposit Guarantee Fund (ODGF), a private insurance fund. ODGF was funded by deposits from member institutions, consisting mostly of small and conservatively managed thrifts with assets under $50 million.

The collapse of ODGF's largest member, Home State Savings Bank of Cincinnati (with assets of more than $1.4 billion), bankrupted the fund and led to large and increasing deposit withdrawals at many other ODGF institutions.[2] ODGF-insured institutions were closed for five days to stop deposit runs. This action also gave time for state and federal officials to assess the severity of the situation and for state legislators to pass emergency legislation dealing with the crisis.

The closed institutions were allowed to reopen on a case-by-case basis depending on their financial condition. Deposit withdrawals, however, were limited until these institutions qualified for federal deposit insurance.[3]

To protect deposits, the state offered financial assistance for organizations to purchase financially troubled ODGF institutions. It also authorized out-of-state depository institutions to acquire these thrifts and to operate them either as thrifts or as commercial banks.[4]

Contrary to common belief, the crisis did not seriously impair the financial health and performance of all 70 ODGF thrifts. Those that were better managed and more capitalized obtained federal deposit insurance and resumed operations as independent depository institutions.

In this *Economic Commentary,* we discuss briefly what happened to the ODGF thrifts. We then examine the current financial condition of the surviving ODGF thrifts by comparing their performance to the performance of other similar-sized thrifts in Ohio.

The thrifts that have survived the 1985 ODGF crisis as independent depository institutions have performed better than similar-sized thrifts in Ohio because they have been able to hold down costs and improve their net worth through higher earnings.

Survivors

Within two weeks of the moratorium, state and federal examiners determined that 26 ODGF institutions would qualify for federal deposit insurance with minor adjustments. These thrifts were fundamentally sound and could have viable futures. In contrast, 18 ODGF institutions were initially insolvent, that is, their liabilities were greater than their assets.

The remaining 26 thrifts were solvent according to generally accepted accounting principles but lacked sufficient capital to qualify immediately for federal deposit insurance.

By April 1986, all ODGF institutions were fully opened for business either as independent depository institutions or as offices or subsidiaries of larger depository organizations. Twenty-six institutions, including Home State Savings Bank, were merged into or acquired by other federally insured institutions and ceased to exist as independent thrift institutions. Two major acquirers were Chase Manhattan Corporation of New York and Home Savings of America, Los Angeles.

ISSN 0428-1276

The 44 other ODGF institutions received approval for federal deposit insurance either from the Federal Deposit Insurance Corporation (FDIC) or from the Federal Savings and Loan Corporation (FSLIC). Several of these institutions, including five of the ten ODGF institutions that became FDIC insured, were acquired by or merged with other depository institutions since 1985.

We examined the current financial condition of 26 surviving ODGF institutions that are operating today as FSLIC-insured thrifts and are not subsidiaries of depository organizations.[5] No doubt these thrifts came from the ODGF's cream of the crop and were probably in better financial shape than the typical Ohio thrift when they obtained federal deposit insurance. However, the ODGF crisis could have longer-term adverse effects on those institutions that were associated with the defunct insurance fund. If so, their current financial performance might be inferior to the performance of other federally insured thrifts in Ohio.

To minimize the potential impact of institutional size on thrift performance, we excluded from our analysis thrifts with deposits over $350 million, because the largest ex-ODGF institution had deposits of $336 million at year-end 1987. After this adjustment, we had 177 thrifts in our control group.

Performance was measured by capitalization and profitability using 1987 data. Performance differences were linked to variations in income and expenses, which in turn were related to differences in the composition of assets, loans, and deposits. For each of these measures, we calculated an average value for the ex-ODGF thrifts and an average value for all other Ohio thrifts of similar size. Using a simple statistical method, we then tested to see if the averages were significantly different. The average values for the two groups of thrifts and the differences between them are presented in tables 1 and 2.

■ Performance

The ex-ODGF thrifts clearly outperformed their counterparts, as shown in table 1. On average, the ex-ODGF institutions are much better capitalized, earn higher returns on assets, and have wider interest-rate margins than other thrifts.

In 1985, the average net-worth-to-asset ratio for FSLIC-insured thrifts in Ohio stood at less than 5 percent. A few years before the ODGF crisis, federal thrift regulators had reduced the minimum capital guidelines for existing FSLIC-insured thrifts from 6 percent of assets to 3 percent because of the financial plight of the thrift industry.

Although the FSLIC and FDIC accelerated the procedure for ODGF institutions to qualify for federal deposit insurance, they did not reduce the thrifts' capital requirements. Like any other depository institution applying for federal deposit insurance, the ODGF thrifts had to have net worth equivalent to at least 6 percent of their assets. Consequently, the ODGF institutions that did qualify for federal deposit insurance were better capitalized than many other federally insured thrifts.

After becoming federally insured, the surviving ODGF institutions also significantly enhanced their net worth. At year-end 1987, they had an average net-worth-to-asset ratio of 7.6 percent, compared to a 5.6 percent capital ratio for other similar-sized thrifts.

The ex-ODGF thrifts earned 0.83 percent on average assets—nearly twice the level of their counterparts. These higher returns can be attributed largely to having a wider, or more favorable, spread between the cost of money and the interest earned on that money. As a percentage of assets, this spread, known as the net-interest margin, was 36 basis points higher at the ex-ODGF institutions than at the other thrifts.

■ Behavior

Despite higher earnings, the ex-ODGF institutions portrayed a more conservative asset structure and loan portfolio than their counterparts, as shown in table 2. For example, as a percentage of assets, the ex-ODGF institutions made fewer loans, which are traditionally riskier than deposits and investments, particularly investments in government securities.

The ex-ODGF institutions also took less credit risk by making more residential mortgage loans and fewer commercial mortgages and construction loans. Nonresidential real estate loans and construction loans collectively accounted for 9.2 percent of the loans held by the ex-ODGF thrifts, compared with 13.1 percent of the loans held by the other thrifts. In addition, other thrifts held a larger share of higher-yielding nonmortgage loans such as consumer installment and business loans.

The ex-ODGF institutions also made a higher percentage of adjustable-rate mortgages than their counterparts. These mortgages carry less interest-rate risk to lenders than fixed-rate loans because the rate changes with movements in interest rates. Despite these differences, yields on loans and mortgages as well as loan fee income were similar at both groups of thrifts.

Higher earnings by ex-ODGF institutions resulted not from taking greater risk or generating higher revenue, but from keeping down costs. Thrift expenses are often divided into three major categories: interest, general and administrative, and nonoperating. Interest expense refers to the cost of money. General and administrative expenses include all expenses involved with overall thrift operations, such as employee salaries and benefits, marketing costs, insurance premiums, and legal fees, as well as expenses of premises and other fixed assets. Nonoperating costs include expenses such as the provision for charging off loans and losses from selling assets.

TABLE 1 THRIFT PERFORMANCE

	Ex-ODGF	Other	Difference
Earnings (percentage of average assets)			
Net income	0.83	0.44	0.39[a]
Net interest margin	2.91	2.55	0.36[b]
Net worth (percentage of average assets)[c]	7.55	5.64	1.91[b]

a. Significant at the 90 percent level.
b. Significant at the 95 percent level.
c. Net worth is based on generally accepted accounting principles.
SOURCE: Federal Home Loan Bank Board's Quarterly Financial Statements.

TABLE 2 THRIFT BEHAVIOR

	Ex-ODGF	Other	Difference
Asset structure (percentage of assets)			
Loans	78.5	82.5	-4.0[a]
Cash, deposits, and investments	19.3	16.2	3.1
Loan composition (percentage of loans)			
Nonresidential mortgages	6.8	9.5	-2.7[b]
Construction loans	2.4	3.6	-1.2[a]
Nonmortgage loans	3.8	5.2	-1.4
Adjustable-rate mortgages	51.4	45.8	5.6
Revenue (average percentage yields)			
Mortgages	8.67	8.65	0.02
Loans	8.74	8.77	-0.03
Expenses (percentage of average assets)			
Money	6.03	6.36	-0.33[c]
General and administrative	2.05	2.45	-0.40[a]
Nonoperating	0.10	0.51	-0.41[c]
Average deposit rate (percent)	6.58	6.81	-0.23[c]
Deposit composition (percentage of deposits)			
Transaction	6.0	4.3	1.7
Savings	40.7	29.6	11.1[c]
Small time[d]	49.4	61.0	-11.6[c]
Large time[e]	3.9	5.1	-1.2[b]

a. Significant at the 90 percent level.
b. Significant at the 95 percent level.
c. Significant at the 99 percent level.
d. Small time deposits are those under $100,000.
e. Large time deposits are those of $100,000 or more.
SOURCE: Federal Home Loan Bank Board's Quarterly Financial Statements.

We might expect to find the cost of money to be higher at the ex-ODGF institutions. Before interest-rate deregulation, one advantage of being an ODGF institution was that deposit-rate ceilings applied only to federally insured institutions. Prior to the moratorium, eight ODGF institutions were paying interest rates between 8 percent and 10 percent on passbook savings accounts.[6] These rates were substantially above the maximum permitted rate of 5.5 percent for FSLIC-insured institutions. Moreover, 33 other ODGF institutions were offering at least 5.75 percent for savings deposits.

Although we do not have savings-rate data for individual institutions, one can presume that the higher-paying institutions were generally more aggressive and more vulnerable to financial distress. Accordingly, many of those institutions probably were merged with or acquired by other institutions after the moratorium.

In any case, we found that the ex-ODGF institutions were not paying higher overall deposit rates than their counterparts during 1987. On the contrary, the average cost of money and deposits was significantly lower at the ex-ODGF institutions. For example, those institutions' average interest cost for deposits was 6.58 percent, compared with an average interest cost of 6.81 percent for deposits of other thrifts.

This differential can be explained to a large degree by differences in deposit composition. The ex-ODGF institutions held a much larger share of deposits in lower-paying transaction and savings accounts than did other thrifts. These deposits collectively accounted for 47 percent of the total deposits held by the ex-ODGF institutions, compared with 34 percent of such deposits held by other thrifts. In contrast, the ex-ODGF institutions had significantly fewer higher-paying time deposits, including large deposits with balances over $100,000 that are uninsured.

In addition to lower funding cost, the ex-ODGF institutions also had much lower nonoperating expenses. The total cost involved with allocating money for bad loans and with selling assets at losses was five times lower at the ex-ODGF institutions than at the other thrifts.

Total expenses would have been even lower at the ex-ODGF institutions, but their operations were more costly than those at other thrifts. Higher salaries and other operating costs caused the ex-ODGF institutions to incur general and administrative costs that were 40 basis points higher as a percentage of assets. This finding by itself might imply that the ex-ODGF institutions were less efficient.

However, an alternative explanation for higher operating expenses is that the ex-ODGF institutions were more retail oriented than their counterparts. Compared to wholesale operations, retail business generally requires more employees and higher operating costs. Although interest expense is typically lower for retail deposits, particularly for consumer transaction accounts, these deposits are more expensive to generate and to service than are wholesale deposits like large time deposits. Also, higher operating costs might be due partly to spending more money on the loan review and collection process in order to minimize credit problems and to maintain low nonoperating expenses.

Conclusion

While all of the institutions involved in the 1985 ODGF crisis were eventually reopened, many of them merged with other institutions and became branch offices. However, 26 ex-ODGF institutions continued to operate as independent thrifts, and these thrifts have performed quite well.

Compared to other similar-sized thrifts in Ohio, the ex-ODGF institutions are more profitable and better capitalized. They achieved higher earnings not by taking more risk or generating higher revenue, but by holding down costs. The ex-ODGF institutions kept down the cost of money by holding a larger share of lower-interest-paying deposits, such as transaction and savings deposits. Also, by holding a smaller share of riskier loans, such as commercial mortgages and construction loans, the ex-ODGF institutions incurred significantly lower nonoperating expenses than did their counterparts.

With higher earnings in 1987, the ex-ODGF institutions improved net worth to 7.6 percent of their assets, significantly above the average for other thrifts. Thus, a sizable number of the ODGF institutions have not only survived, but they are, on average, in better financial condition than their counterparts.

Paul R. Watro is an economist at the Federal Reserve Bank of Cleveland. *The author wishes to thank Mark S. Sniderman, James B. Thomson, and Walker F. Todd for their comments and Daniel J. Martin for his research assistance.*

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Footnotes

1. For a detailed discussion of the Ohio thrift crisis, see the 1985 Annual Report of the Federal Reserve Bank of Cleveland. Background material for this *Commentary* came largely from that report. For a list of the 70 ODGF institutions, see "Protecting the Depositor," Report and Recommendations of the Joint Select Committee on Savings and Loans, 116th Ohio General Assembly, February 1, 1986, Appendix A.

2. Home State Savings Bank failed because of massive losses attributed to dealings with ESM Government Securities, Inc. of Fort Lauderdale, Florida, which went out of business on March 4, 1985. Before deciding not to reopen five days later, Home State experienced net deposit withdrawals of approximately $154 million.

3. Withdrawals were limited initially to a maximum of $750 per month per depositor's account and were later increased to $1,000 per month.

4. Since interstate banking was not permitted in Ohio at that time, the state essentially sold entry privileges to out-of-state acquirers of ODGF institutions. See Edward J. Kane, "Who Should Learn What from the Failure and Delayed Bailout of the ODGF?", Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 6-8, 1987, p. 319.

5. The surviving ODGF institutions that acquired FDIC insurance and became commercial banks are not included in the study because of the lack of comparable data.

6. See 1985 Annual Report of the Federal Reserve Bank of Cleveland, p. 13.

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

BULK RATE
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Address Correction Requested:
Please send corrected mailing label to the Federal Reserve Bank of Cleveland, Research Department, P.O. Box 6387, Cleveland, OH 44101