FRBSF Weekly Letter

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Restructuring the S&L Industry

The recent decline in the level of interest rates has provided the savings and loan (S&L) industry with some much-needed relief. As a result, earnings for 1984 should show some improvement over those for 1983, and S&Ls may be able to post slight gains in their overall net worth positions. Nonetheless, the industry will remain weak without a further sizeable drop in interest rates. Over the last five years, S&Ls' recorded net worth has declined more than 30 percent from 6.1 to 4.1 percent of liabilities. Moreover, the market value of net worth is substantially lower still, given the magnitude of the industry's unbooked losses from depreciation in the value of its low-yielding, long-term assets.

As problems nearly overwhelmed the industry in 1981 and 1982, legislators and regulators worked quickly to implement assistance programs designed to patch up the industry's condition. This *Letter* examines the various forms of assistance granted and evaluates the progress the industry has made in addressing its basic problems. While the industry has enjoyed certain tax subsidies, the actual fiscal impact of the direct assistance has been small in comparison to the magnitude of the problem. In contrast, the implicit (and, therefore, unfunded) guarantees have been enormous and may actually have caused the industry to postpone real solutions to its problems.

Expanded powers

Many have argued that the S&L industry's current problems are due to its lack of diversification in the types and maturities of its assets. An extremely large proportion of the industry's portfolio has been (and still is) invested in long-term, fixed-rate mortgages that make the industry especially vulnerable to housing and interest rate cycles. Consequently, when pressed to provide relief for the industry's worsening condition, regulators and legislators expanded S&Ls' investment powers. The Federal Home Loan Bank Board (FHLBB) loosened various restrictions on the industry's asset powers, including removing some restrictions on the mortgage instrument itself. S&Ls were given great latitude to design adjustable rate mortgage instruments that, in theory, would insulate them from fluctuations in interest rates.

For its part, Congress enacted two major pieces of legislation—the Depository Institution Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982—both of which expanded the menu of assets S&Ls could choose to invest in. For example, the 1980 Act authorized S&Ls to invest in commercial paper debt securities, to offer credit cards, and to make consumer, education and commercial real estate loans. The 1982 Act further expanded S&Ls' investment powers to include obligations of state and local governments, time and savings deposits of other S&Ls, and tangible personal property. In addition, S&Ls were given authority to make commercial loans and Small Business Investment Corporation loans. While these Acts, as well as certain tax considerations, impose limitations on S&Ls' investments in each of the new areas, the restrictions are not likely to become binding for a long time to come, if ever. With these two pieces of legislation, then, S&Ls presumably need no longer confine themselves to housing finance, or limit their investments to long-term assets.

Capital assistance

By early 1982, however, the industry's losses were large enough to threaten what remained of many S&L's recorded net worth. Consequently, legislators and regulators decided to buy time for the industry to restructure itself. Assistance came largely in the form of various implicit and explicit off-budget guarantees of the industry's net worth. In the Garn-St Germain Act of 1982, for example, Congress authorized *explicit* capital assistance for the industry by directing the Federal Savings and Loan Insurance Corporation (FSLIC) to set up a net worth certificate program. By allowing qualifying institutions to issue net worth certificates in exchange for the FSLIC's promissory notes, this program created additional net worth for the industry without requiring federal cash outlays unless the institutions receiving aid failed.

The FHLBB, moreover, has given the industry substantial *implicit* capital assistance that also has not entailed any direct federal outlays. Through various changes in its regulatory accounting principles (RAP), the FHLBB allowed S&Ls to include in

net worth such questionable items as "appraised equity capital." Moreover, the industry now has considerable "intangible assets" arising from deferral and purchasing accounting. These changes augmented the industry's recorded net worth by an estimated $21 billion at year-end 1983. (For discussion of net worth certificates and RAP techniques, see the *Weekly Letter* of December 21, 1984.)

In addition to these accounting changes, the FHLBB has provided implicit capital assistance to the industry by lowering regulatory net worth requirements in two steps from an average of 5 percent of liabilities in early 1980 to 3 percent in January 1982. Such a reduction was clearly intended to assist the industry since the condition of most S&Ls at the time posed risks for the insurance system that could have warranted higher net worth standards.

Moreover, the FHLBB's decisions to reduce net worth requirements and allow what amounted to a redefinition of regulatory net worth indirectly generated tax benefits for the industry. Changes in RAP enabled S&Ls to sell off low-yielding assets to generate cash for reinvestment without having to record immediate losses on the sale of those assets. At the same time, S&Ls could record immediate losses for tax accounting purposes, thereby substantially reducing their tax liabilities.

Insolvency vs. illiquidity

The capital assistance provided by Congress and the FHLBB indeed has bought the S&L industry time. Despite substantial consolidation (more than 700 institutions have been liquidated or merged out of existence), the industry itself is still intact and, in some respects, thriving. In 1983 and 1984, for example, the industry's assets grew at an annual average rate of 9.5 percent. This growth is especially noteworthy given the magnitude of the prior deterioration in the market value of the industry's long-term assets.

The use of book valuation masks the large decline in the industry's true net worth position. If the industry were required to recognize its heretofore unbooked losses, its net worth position would fall from 4.1 percent to an estimated −3.7 percent of liabilities, based on an approach developed by Kane. These losses arose because the contract interest rate on many of the industry's long-term mortgages is less than the prevailing market rate. The resulting depreciation in value eventually appears on S&Ls' books as a low (relative to prevailing rates) recorded yield on assets. However, it may take many years for this reduced income stream to show the full effect of the decline in the portfolios' market value.

In effect, then, S&Ls have been able to use book value accounting to defer the recognition of capital losses as long as the assets in question remain in portfolio. Should investors become wary of the condition of an S&L with substantial unbooked losses and begin to withdraw funds, however, that S&L may be forced to sell its "underwater" assets and recognize its losses; the effect would be to wipe out its net worth. Without some assistance from its regulator, such an S&L presumably would be forced into bankruptcy.

Although many firms in the industry are technically insolvent (i.e., the market value of their net worth is zero or negative), they will not fail as long as the FHLBB is willing to allow these institutions to stay in operation. Because the Federal Savings and Loan Insurance Corporation (FSLIC) explicitly insures at least 72 percent of S&Ls' liabilities and the Federal Home Loan Banks hold another 7 percent in the form of advances, the failure to close insolvent institutions means that these government institutions are underwriting the industry's losses. One could even argue that "uninsured" investors are protected as long as the FHLBB gives them sufficient time to withdraw their funds prior to closing a failing institution.

The FHLBB's seeming willingness to underwrite staggering losses is perhaps hard to understand since prompt action to close failing institutions as they become insolvent would have substantially reduced the FSLIC's present exposure. Such action, however, would have required a redefinition of insolvency using a market valuation of net worth. Moreover, because of the S&L industry's lack of diversification, the deterioration in its condition as rates began to rise was not limited to a few associations but was nearly universal. Thus, by the time the problem was recognized, it would have been difficult for the FHLBB to take action without exhausting the deposit insurance fund.

As a result, the FHLBB chose to allow insolvent institutions to continue in operation, in effect, pretending that their losses did not exist. As a result, the industry's negative net worth, which may be as

low as negative $30 billion, exceeds the resources of the $6.3 billion insurance fund. This disparity represents an unfunded guarantee of S&Ls' solvency, which the Treasury and taxpayers would have to underwrite if depositors and investors were to lose confidence in the insurance system.

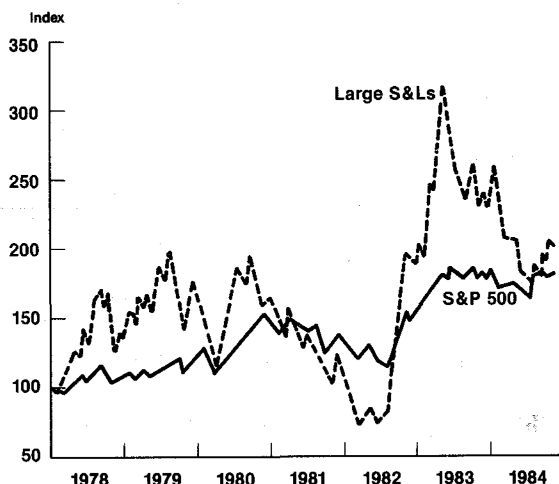
Risk-taking and restructuring

The existence of these unfunded guarantees, moreover, encourages S&Ls to undertake excessive risks. As Kane (*Housing Finance Review,* July 1982) has argued, the FHLBB's actions with regard to regulatory net worth requirements have had the effect of reducing the cost of deposit insurance and of increasing both the value of these guarantees and the value of an S&L charter. The behavior of S&L stock prices (see chart) supports this line of reasoning. While large S&Ls' stock prices deteriorated significantly during the darkest days of 1981-82, their appreciation since then seems out of line with the meager improvement in the industry's condition. Government assistance programs probably account for a substantial portion of this appreciation and, as a result, may be discouraging the industry from reducing its exposure to risk.

A study by Kaplan-Smith & Associates (an S&L consulting firm) shows that the S&L industry has not reduced its exposure to interest rate risk since 1981. Thanks to the considerable expansion of its asset powers, the industry has reduced its proportionate investment in mortgage loans from 80 percent of total assets in 1981 to 63 percent in June 1984, and increased its investment in cash and marketable securities by 26 percent to 18 percent of total assets. However, the industry used an influx of short-term funds primarily to pay down longer term liabilities. This left the industry's sensitivity to interest rate risk about unchanged.

Likewise, since 1982, the use of adjustable rate mortgages (ARMs) has grown steadily, with ARMs now accounting for 67 percent of all new mortgages issued by S&Ls. This increase undoubtedly reduces the industry's exposure to rate risk by transferring that risk to borrowers. Nonetheless,

Stock Price Indexes for Large S&Ls*and the Standard and Poor's 500 Stocks



* Equally weighted weekly price movements of a sample of 21 S&Ls with deposits over $1 billion.

the proportion of ARMs in the industry's overall mortgage portfolio remains at only 14 percent at the end of 1983. Moreover, since many associations apparently reduced their underwriting standards to make ARMs more marketable, increased exposure to default risk may have supplanted exposure to rate risk.

This seeming lack of significant restructuring by the S&L industry will continue to be a problem for the regulators as long as implicit and explicit net worth guarantees are given technically insolvent institutions to help them continue in operation. In effect, the FHLBB and other government institutions are underwriting the industry's losses and discouraging S&Ls from taking steps to reduce their exposure to risk. As a means of reducing the value of the unfunded guarantees the industry now enjoys, the FHLBB ought to consider phasing in tougher net worth requirements, including adopting a market-value definition of insolvency, and closing the weakest institutions.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/26/84	Change from 12/19/84	Change from 12/28/83 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	189,718	1,361	13,693	7.7
Loans and Leases[1] [6]	171,366	1,412	16,011	10.3
Commercial and Industrial	53,383	435	7,420	16.1
Real estate	62,018	73	3,119	5.2
Loans to Individuals	32,000	314	5,349	20.0
Leases	5,079	0	16	0.3
U.S. Treasury and Agency Securities[2]	11,265	– 82	– 1,242	– 9.9
Other Securities[2]	7,087	32	– 1,076	– 13.1
Total Deposits	195,464	1,096	4,467	2.3
Demand Deposits	46,891	602	– 2,346	– 4.7
Demand Deposits Adjusted[3]	32,188	2,049	857	2.7
Other Transaction Balances[4]	12,634	– 1	– 141	– 1.1
Total Non-Transaction Balances[6]	135,939	495	6,954	5.3
Money Market Deposit Accounts—Total	41,429	338	1,832	4.6
Time Deposits in Amounts of $100,000 or more	41,236	242	3,071	8.0
Other Liabilities for Borrowed Money[5]	20,745	–1,713	– 2,262	– 9.8

Two Week Averages of Daily Figures	Period ended 12/17/84	Period ended 12/03/84
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	40	65
Borrowings	44	51
Net free reserves (+)/Net borrowed(–)	– 3	13

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change