FRBSF Weekly Letter

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FIRREA and the Future of Thrifts

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) provides the funds to begin closing and/or reorganizing the hundreds of insolvent savings and loan associations that contributed to the so-called thrift crisis. In addition, it alters the legal and regulatory environment for the remaining institutions by changing the laws governing the deposit insurance funds, thrift powers, bank holding company acquisition of thrifts, and capital requirements. This *Letter* discusses the implications of each of these new rules for the future operating environment and size of the thrift industry.

New insurance funds

FIRREA establishes two new deposit insurance funds, replacing the fund administered by the Federal Savings and Loan Insurance Corporation with the Savings Association Insurance Fund (SAIF) and the fund administered by the Federal Deposit Insurance Corporation (FDIC) with the Bank Insurance Fund (BIF). The Act places both funds under the administration of the FDIC.

These funds offer the same protection to depositors, but differ in the level of their reserve ratios (the ratio of insurance fund reserves to insured deposits) and therefore, in the size of the premia charged to their member institutions. FIRREA requires BIF and SAIF to build and maintain a "designated reserve ratio," which is now set at 1.25 percent of insured deposits. Because SAIF's reserve ratio currently is considerably lower than this target, FIRREA requires SAIF members to pay substantially higher premia than BIF members. BIF members now pay 12 cents per $100 of deposits, while SAIF members must pay 20.8 cents.

Over time, this differential will narrow, with BIF and SAIF members paying 15 and 18 cents, respectively, for each $100 of deposits between August 1994 and January 1, 1998. After January 1, 1998, this differential is expected to disappear altogether, and members of both funds will be paying 15 cents for each $100 of deposits.

However, beginning on January 1, 1995, the FDIC is permitted to raise premia for either insurance fund above the statutory levels set in FIRREA, if it determines that reserve ratios are likely to fall below the designated reserve ratio of 1.25 percent. Thus, the premium differential between SAIF and BIF may persist even after 1998.

BIF or SAIF?

The sizeable differential between SAIF and BIF premia may encourage institutions to convert their memberships from SAIF to BIF. However, depository institutions cannot convert from one deposit insurance fund to the other until five years after enactment of FIRREA, which will be August 1994. Exceptions may be made for insolvent thrifts or those in danger of default and for relatively small thrift branches.

When the moratorium is lifted, any thrift or bank can convert from one insurance fund to the other. To convert, a depository will have to change its charter, merge with an institution belonging to the other fund, or acquire a branch or branches from an institution in the other fund. The converting institution also will be required to pay both an exit fee to the fund it is leaving and an entrance fee to the fund it is joining.

FIRREA mandates that the FDIC set entrance fees sufficiently high to prevent "dilution of the fund" being entered. This means that an institution seeking to convert from SAIF to BIF likely will have to pay entrance fees approximately equal to BIF's reserve ratio. Thus, if BIF succeeds in building its reserve ratio to 1.25 percent or higher by August 1994, institutions entering BIF will probably pay an entrance fee of at least $1.25 per $100 of insured deposits.

Given such a high entrance fee and assuming that the premium differential in August 1994 (when the moratorium is lifted) is only three cents per $100 per year, as FIRREA mandates, conversions from SAIF to BIF are not likely.

Moreover, any exit fees charged for leaving SAIF would further discourage conversions.

Persistent differentials?
However, if thrifts expect premium differentials to persist indefinitely, a substantial number of conversions could take place, despite the hefty entrance and exit fees. Given the large number of thrift insolvencies, many may believe that SAIF premia will remain permanently higher than BIF premia in order to maintain reserves in the face of future losses.

Faced with the expectation of permanently higher premia, savings and loans with sufficient cash flow to cover the exit and entrance fees likely will convert. In fact, any thrift with a strong net worth position could be a candidate for conversion since at the very least, it should be able to borrow against its net worth to raise the money to cover exit and entrance fees.

Thus, it is possible that only the weaker institutions would be left behind in SAIF. Since weak institutions pose the greatest risks and therefore impose the greatest costs on the insurance funds, SAIF premia may have to increase to cover the higher expenses associated with a growing concentration of weak institutions. Higher premia, in turn, may encourage even more defections from SAIF and an even greater concentration of weak thrifts in SAIF.

Switching charters
Although a thrift may not convert from SAIF membership to BIF membership until August 1994, it is permitted at any time to convert to a bank for all other purposes. It needs approval for charter conversion from the appropriate regulatory agencies, but once it gains such approval, a thrift can call itself a bank and exercise bank powers. A thrift that converts to a bank charter will have the choice of staying with SAIF or moving to BIF after the moratorium on insurance fund conversion expires.

Even if a thrift chooses not to convert from SAIF to BIF, it may want to change to a bank charter because provisions in FIRREA reduce the attractiveness of a thrift charter relative to a bank charter. First, FIRREA diverts some of the earnings of the Federal Home Loan Banks in which thrifts hold stock. This will reduce the dividends thrifts receive from the Home Loan Banks. Second, FIRREA alters the activities and investments that are permissible for thrifts.

Under FIRREA's Qualified Thrift Lender (QTL) test, a thrift must have 70 percent of its tangible assets in "qualified thrift investments," which are generally housing-related assets. Formerly, thrifts were required to hold only 60 percent of their portfolio in such investments, and the list of assets deemed housing-related was broader than under FIRREA. Historically, thrifts have had tax advantages over banks that compensated them for these portfolio restrictions. These tax advantages remain, but they have not been enhanced in response to the new investment rules.

Banks, in contrast, have much broader lending powers and are not required to hold housing-related investments. A bank thus has more flexibility to take advantage of profitable investment opportunities and to diversify its portfolio.

A wall comes down
Prior to FIRREA's enactment, bank holding companies were prohibited from acquiring all but insolvent thrifts. FIRREA amends the Bank Holding Company Act to authorize the Federal Reserve to permit bank holding companies to acquire healthy thrifts.

The new rule may increase the number of thrifts purchased by bank holding companies. Many of these acquired thrifts are likely to be converted to bank charters because of the investment restrictions on thrifts and because a bank holding company may find it more efficient to run a depository institution subsidiary as a bank than as a thrift.

Thrifts that are acquired by bank holding companies also may, with certain restrictions, be merged into affiliate banks. This option will be attractive whenever the holding company can take advantage of economies associated with a larger scale of banking operations. The merged entity will have to pay SAIF premiums on the portion of deposits attributable to the thrift until August 1994, though.

New capital requirements
FIRREA introduces three new capital requirements for thrifts. First, FIRREA imposes a new minimum "leverage ratio." The leverage ratio, defined as the ratio of "core capital" to total

assets, is to be no less than three percent. Core capital is the sum of common equity, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries, minus most intangibles except purchased mortgage servicing rights and qualifying supervisory goodwill. (Supervisory goodwill is the premium above tangible net worth that may be paid for a *troubled* savings institution. Acquirers may be willing to pay such premium to obtain the deposit insurance guarantee.)

Second, FIRREA requires compliance with a new minimum 1.5 percent tangible-capital-to-assets ratio. Tangible capital is core capital minus supervisory goodwill and all other intangibles except qualifying purchased mortgage servicing rights.

Finally, FIRREA establishes a minimum risk-based capital requirement for thrifts. Risk weights are applied to a thrift institution's assets according to the assets' inherent riskiness. This yields the risk-adjusted asset base against which a minimum amount of capital must be held.

Goodwill

In addition to the new capital-asset ratios, new definitions of capital are in effect since FIRREA's enactment. Thrifts are no longer permitted to include most types of "goodwill" in regulatory measures of capital. Moreover, even supervisory goodwill is to be phased out of core capital by 1995. Goodwill is the difference between the market value of a firm's net worth and the value based on tangible assets only. Goodwill represents the value of a franchise, including name recognition, an established reputation, and loyal customers. For many thrifts, goodwill was booked as capital when they acquired other enterprises at greater-than-tangible asset value.

For weak thrifts, the new rules pertaining to goodwill are especially appropriate. The only source of goodwill for these thrifts was the unpriced value of the deposit insurance guarantee and the forbearance practiced by the regulators. The exclusion of goodwill from capital will thus be reflected in lower stock prices for these thrifts.

For healthy thrifts, however, excluding goodwill from regulatory capital may have undesirable effects. A healthy thrift that was operating efficiently prior to FIRREA would have chosen an optimal capital level, including goodwill. If its capital, excluding goodwill, is less than the regulatory minimum, FIRREA will force the thrift to raise additional capital. This presumably will lead to a decrease in the wealth of the thrift's shareholders, since the institution will be required to operate with greater-than-optimal capital. (It is worth pointing out that *any* increase in capital due to the new capital requirements would for the same reason diminish thrift shareholder wealth. From a social standpoint, however, there is an offsetting reduction in the value of potential claims on the insurance funds.)

Perhaps the only way for these shareholders to recover this lost wealth would be to sell the thrift. A purchaser should be willing to pay for the full value of the goodwill, as long as the purchaser does not also face the same regulatory capital deficiency problem as the acquiree. Thus, the new requirement concerning goodwill could lead to increased thrift takeovers, particularly by bank holding companies, which are not likely to be as capital-constrained as are thrift holding companies.

The exclusion of goodwill and the new capital-asset ratios are in sum more stringent than pre-FIRREA requirements. They will cause some thrifts that are unable to raise enough capital to close down. Many other thrifts will be able to raise the necessary capital only by selling off assets and/or slowing growth. These requirements, therefore, will cause the industry to shrink considerably, at least over the next several years.

An uncertain future

It is too early to tell whether bank holding companies will acquire healthy thrifts on a large scale, and we will have to wait five years to observe the extent of conversions from SAIF to BIF. However, it is clear that the operation of a savings and loan is a very different business from what it was less than six months ago. Higher deposit insurance premia for thrifts, restricted thrift activities, the prospect of bank holding company acquisitions of thrifts, and stiffer capital requirements all contribute to the likelihood that the thrift industry will experience considerable consolidation in the wake of the deposit insurance crisis.

Elizabeth Laderman
Economist

Research Department
Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120