Savings and Loan Associations in the New Financial Environment

James A. Verbrugge, Professor and Chairman, Department of Banking and Finance, University of Georgia, suggests that regulators need to be looking for alternatives to merging troubled thrifts with healthier institutions. In the longer run, more research is needed on questions of capital adequacy, interest rate risk, and maturity imbalances in the new environment.

The implications of the Deregulation Act for thrift institutions are both serious and sweeping. The pessimistic view is that the Deregulation Act has signaled the beginning of the end for the S&L industry. A more optimistic view is that the Deregulation Act represents the demise of the industry as we know it, but also represents the threshold of a new era of opportunities for thrift institutions.

Without rehashing past history, it is clear that the Deregulation Act was the final product of a long series of financial reform efforts over the past fifteen years.[1] Pressures to reform the financial system intensified after Regulation Q was extended to thrift institutions in 1966. These pressures originated from a variety of sources and for a variety of reasons, some of which were the realization that Regulation Q discriminates against small savers, the recognition of the problems created by the maturity imbalance of thrift institutions in an era of volatile and upward trending interest rates, and the development of innovations in the financial markets (e.g., money market mutual funds). Previous efforts at reform were piecemeal: the development of longer-term CDs for thrifts in the early 1970s, the introduction of the MMC in 1978, the regional experiments with NOW accounts, and the use of variable rate mortgages on a limited geographic basis. It was inevitable that legislation similar to the Deregulation Act would be passed. The issue was not if, but when.

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[1] These earlier proposals include, for example, the Friend Study, the Hunt Commission Report, the Financial Institutions Act, the FINE Study, and the Financial Reform Act.

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true financial reform. For many years (and to some extent, even now), the major thrust of the industry was to preserve Regulation Q and the differential at all costs. Had the industry been willing to give up Regulation Q for additional meaningful powers at an earlier date, it now would be far better equipped to deal with the problems it faces in the current volatile financial environment.

However, this is all history. The relevant questions now concern the effects of the deregulation and the implementation of broader powers provided for thrifts by the Deregulation Act.

What is outlined below is not intended to be an exhaustive list of questions but merely some which appear to be most important. The questions are divided into two categories; (1) those associated with the period of transition and (2) more fundamental, long-run effects of the Deregulation Act on thrifts. While the latter issues are clearly of greater academic and intellectual interest, the former will determine whether or not the thrift industry will survive to share in the benefits of less regulated financial markets.

The Period of Transition

The most immediate and important issue facing S&Ls and the regulatory agencies is how to deal with the critical problems facing thrifts during the period of transition to the deregulated environment envisioned by the legislation. The basic problem is that the liability side of S&Ls has already become quite interest-rate sensitive as a result of the rapid growth of six month MMCs and jumbo CDs, and is likely to become more sensitive as decontrol of deposit rates progresses over the next several years. On the asset side, however, the benefits of deregulation and broadened powers will accrue slowly over a relatively long period of time. For most S&Ls, the portfolios are dominated by fixed-rate-mortgages, many of which carry yields considerably below prevailing market rates on funds. In many cases, the yield-cost spread for individual associations is negative. As a result, unless associations have a substantial amount of liquid assets whose yields have kept pace with the cost of funds, profits are near zero or negative. For those associations with healthy net-worth positions, this is a painful but not terminal problem. For those associations with minimum capital positions, there is a real danger of failure in this situation. Several important policy questions arise from this issue.

1. What should be the policy of the regulatory agencies toward associations in real danger? Of course, the best solution is that the current efforts to reduce inflation succeed and that interest rates, particularly short-term rates, fall. Should this occur, the earnings squeeze would dissipate quickly over several quarters as MMCs are rolled over at lower rates.

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In the absence of interest-rate decreases, a serious question remains. What should be the policy of the FHLBB and the FSLIC toward problem and near-failure associations? Should we allow failures which are not the result of poor management or fraud but are the result of interest-rate risk which has been imposed on the institutions due to regulatory constraints? Or, should there be some sort of assistance to associations which find themselves in this situation? The approach taken thus far has been to merge troubled S&Ls with healthier associations. In a number of cases, the FSLIC absorbed assets (approximately $1.3 billion in 1980) of extremely weak associations. Other measures under consideration include further changes in net worth requirements and the use of the FSLIC as a source of capital for troubled thrifts.[2]

[2]The suggestion of the FSLIC as a source of capital originated in a paper by Verbrugge and Dince (1979). Ironically, the idea was never intended as a source of capital for weak and troubled S&Ls. It was suggested as a means of raising capital, primarily for mutuals, who were experiencing temporary net-worth difficulties due mostly to rapid growth.

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2. Is there any danger of a loss of public confidence in S&Ls as a result of the troubled situation in the thrift industry? No insured S&L depositor has ever experienced a loss. However, with the seriousness of the earnings squeeze and the publicity given to the troubles of thrifts, there is the possibility of some loss of public confidence in thrifts.

Longer-Run Issues

Assuming that the thrifts and regulators muddle through the transition period without disastrous results, there are a number of more fundamental questions regarding thrifts and the new financial environment.

Models of S&L Behavior Under Deregulation

The key issue here is the type of S&L which will emerge as the most viable institution on a deregulated market; i.e., what should be the mode of operations for a viable S&L in the 1980s? Basically, there are three alternatives: (1) the classical or traditional S&L, (2) a real estate related association coupled with a mortgage-banking orientation, and (3) a family financial center. The first would be a business-as-usual S&L concentrating on deposit acquisition and traditional mortgage lending. In all likelihood, this type of operation is doomed to extinction. The second type would be heavily oriented toward real estate development loans with only a moderate role for residential lending. Service corporations would play an important role in this type institution. In addition, the association would focus on mortgage banking activity by originating, buying, selling, and servicing loans instead of originating mortgages for its own portfolio. The third type would become a one-stop consumer finance supermarket with a full range of consumer services including consumer and mortgage loans, transactions accounts, traditional deposits, credit cards, etc.

Capital Adequacy

This issue is as pertinent for S&Ls as it is for banks with many of the same problems. What is adequate capital? How should capital considerations be tied to deposit-insurance considerations? Is a liability based net-worth requirement meaningful?

The issue for S&Ls is clouded by one additional consideration, namely, the mutual form

THE FUTURE S&L: Three Alternatives

Traditional Mortgage Lending

Real Estate Development Lending

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of organization. Currently, mutuals can obtain additional capital only through retained earnings from profits. The only option for obtaining additional capital is to convert to the stock form of organization, a movement which is occurring at a rapid rate. Other options, like mutual capital certificates, appear to have limited usefulness.[3]

Managerial Motives and the Mutual vs. Stock Issue

Several recent banking studies have questioned the traditional assumption of profit maximization in banking under conditions of monopoly power.[4] In other words, banks with monopoly power may reward the management instead of stockholders by hiding profits under salaries and prerequisities (a tendency known as "expense-preference").

Similar questions can be raised concerning S&Ls with market power. In addition, since mutuals do not have traditional owners, there is some question regarding the motivation of mutual managers. Unlike stock institutions, mutual associations do not necessarily make a profit. Following the lines of banking studies, several recent papers have addressed the stock-mutual question.[5]

In these studies, it was found that mutual S&Ls exhibit expense-preference tendencies and that they also tend to have preference toward lower risk portfolios. Further efforts in this area are warranted.[6]

Interest Rate Risk Management in S&Ls

The basic financial management issue facing S&Ls is, of course, how to manage interest-rate risk. In the current financial environment, interest-rate intermediation (the process by which an institution takes deposits and invests them, in this case involving short-term liabilities and long-term assets) is extremely risky. As outlined above, the family financial center S&L and the mortgage banking S&L models do reduce some of the interest-rate risk by selling loans instead of retaining them in the portfolio and by engaging in shorter-term consumer lending. However, long-term mortgage lending and short-term deposit acquisition are still important features in both models. Unless variable-rate mortgages are issued which allow changes in rates very frequently, S&Ls will still face considerable interest-rate risk.

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The question then becomes how to deal with the remaining interest-rate risk and maturity imbalance. One alternative is the use of the financial futures market in which the institution could hedge its exposure to interest-rate risk. Traditional use of the interest-rate futures market has emphasized the process of hedging against the rate movement of a specific asset or liability.[7]

More recently, it has been suggested that the optimal approach is the maturity-imbalance hedge which is simply a hedge of the overall maturity imbalance risk exposure of the firm.[8]

There is an obvious need for considerable research regarding the role of interest-rate futures in thrift-institution management.

Miscellaneous Issues

There are, of course, numerous other questions and issues which can be raised regarding

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[3]The capital issue for S&Ls is considered in detail in Verbrugge and Dince (1979) and Verbrugge and Dince (1980).

[4]For example, see Edwards (1977) and Edwards and Heggestad (1973).

[5]Verbrugge and Goldstein (forthcoming 1981), Verbrugge and Jahera (1979), and Taggart (1978).

[6]Perhaps some additional light on this issue can be obtained from recent work on agency theory. Jensen and Meckling (1976) and Fama (1980).

[7]Schweser, Cole, and D'Antonio (1980).

[8]The maturity-imbalance hedge is a short position whose function is to offset the volatility of the firm's profitability. For a complete explanation see Riordan and Hartzog (1980) and Hartzog (1981). The paper by Thygerson (1980) also contains useful material regarding hedging with interest-rate futures.

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thrifts in the post-Deregulation Act world. To list several —

• Will the FHLBB, and other regulatory agencies, be able to resist the temptation to continue their role as protectors and supporters of the industries they serve? Or, will they be able to reverse past patterns and espouse a market-oriented regulatory philosophy?

• What is the appropriate merger policy in the new environment? Inevitably, the question of bank and S&L mergers must be addressed as well.

• The structure of both the banking and S&L industry is likely to undergo significant change as the effects of the Deregulation Act and other aspects of deregulation (breaking down of geographic barriers) are fully realized. As a result, it will be important to study the effects of these changes on market concentration and the performance of financial institutions. Furthermore, most studies have failed to account for inter-industry competition. As competition between banks and S&Ls intensifies, this issue can no longer be ignored.

• How beneficial are equity participations (shared appreciation) loans to thrifts and to borrowers? Is there a role for a traditional lender in a market where equity financing may take on increased importance?

Conclusion

There is no doubt that price competition between banks and thrifts will intensify over the next decade in both funds acquisition and lending. The basic questions are whether thrifts have been given the necessary flexibility to compete effectively in this market and whether thrift managers will implement the new powers successfully. The heightened competition appears certain to weed out inefficient firms, improve the efficiency of survivors, and leave consumers better served. ER

—James A. Verbrugge

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