Financial Industry ISSUES

FEDERAL RESERVE BANK OF DALLAS FOURTH QUARTER 1995

Can Banks Learn From Thrifts?

In September, legislation was introduced into Congress that would effectively eliminate the thrift charter. Under the proposed Thrift Charter Conversion Act, which would take effect January 1, 1998, all federally chartered thrifts would convert to a national bank charter or to a state depository institution charter. Federal banking law would treat all state-chartered depository institutions as banks. The act also contains measures that would capitalize the Savings Association Insurance Fund (SAIF), merge SAIF with the Bank Insurance Fund (BIF) and consolidate the federal bank and thrift regulatory agencies. Continuing problems with SAIF have motivated Congress to consider ending the distinction between banks and thrifts.

The current debate over reforms in the banking industry parallels the thrift industry's demise in some important ways. Outdated restrictions on the activities of thrifts hampered their ability to compete in financial markets. Legislation currently before Congress to expand the permissible range of banking organizations' activities should be viewed with special attention to the role that legislative and regulatory restrictions played in the financial difficulties faced by the nation's thrift industry. While intended to limit risk exposure at insured depository institutions, regulations can often have the unintended consequence of undermining the economic viability of the industry itself.

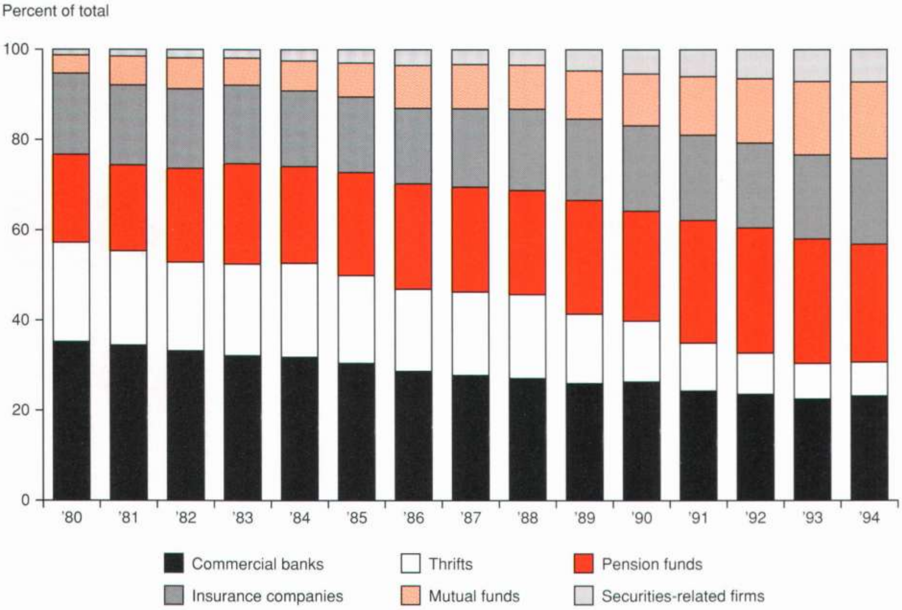
The Thrift Charter Conversion Act

Efforts to increase SAIF's reserves to the 1.25 percent (or $1.25 for every $100 of insured deposits) mandated by Congress led to Congress' consideration of the Thrift Charter Conversion Act. Currently, SAIF's reserve ratio stands at 0.40 percent. On the other hand, BIF achieved its designated reserve ratio of 1.25 percent in May. As a result, for the first time in its history, the Federal Deposit Insurance Corporation voted to reduce its insurance premiums for well-capitalized, well-managed banks (over 90 percent of the industry) to zero. However, thrifts are still required to pay premiums in the range of 23 to 31 basis points. Such a gap in insurance premiums could motivate thrift institutions to move deposits to BIF-insured affiliates. In congressional testimony, Federal Reserve Chairman Alan Greenspan has pointed out that this type of regulatory arbitrage results in a waste of valuable resources. He also described the current disparity in deposit insurance premiums as inherently unstable.

In recognition of the difficulties plaguing SAIF and the potential effects arising from the disparity in deposit insurance premiums, Congress decided to take steps to merge the two insurance funds and to link this merger with the issue of charter conversion. Because of the thrift industry's role as a specialized mortgage lender, some industry observers have expressed concerns that housing finance could be adversely affected by the elimination of the thrift charter. However, while thrifts were once considered to be the dominate players in the provision of housing finance, market forces and technology have combined to lessen considerably the role of thrifts in the mortgage market, particularly with the advent and spectacular growth of the secondary mortgage market.

Reflecting the diminishing importance of thrift institutions, thrift assets have declined markedly as a percentage of the assets of all major

Chart 1
Financial Assets Held by Major Intermediaries



DATA SOURCE: Flow of Funds Accounts, Z.1 Release.

financial intermediaries. In 1980, thrifts held a market share of 22 percent. Since that time, however, their relative asset base has shrunk to about 7 percent, as shown in Chart 1. Meanwhile, pension funds, mutual funds and securities-related firms have gained market share, reflecting the heightened importance of securitization in the overall process of financial intermediation.

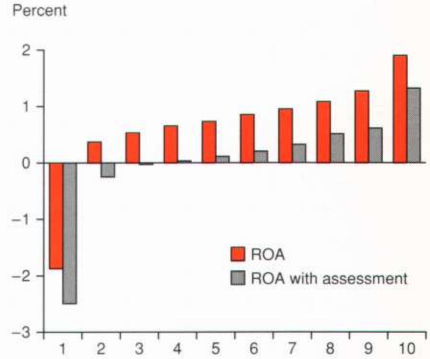
Prior to any merger of BIF and SAIF, Congress is considering a one-time assessment of 85 basis points on all thrift deposits to increase SAIF's reserves to the designated 1.25 percent. Such an assessment is expected to raise approximately $6 billion and would likely have a substantial impact on reported earnings. Chart 2 shows thrift profitability in the first quarter of 1995, as measured by annualized return on assets. While considerably smaller than in the late 1980s, the entire industry has regained strength. Only those thrifts in the bottom 10 percent of all thrifts, in terms of profitability, recorded a median return on assets (ROA) below zero in the first quarter, while the median ROA of the top 10 percent of thrifts was a healthy 1.9 percent. However, if the one-time assessment were applied to deposits as of March 31, 1995, and the resulting charge were subtracted from annualized earnings, the reported ROA for all groups of thrifts would decline fairly substantially. The median ROA for those thrifts in the bottom 10 percent in terms of profitability would decline from –1.9 to –2.5 percent, as shown in Chart 2. The top 10 percent of thrifts would record a decline in ROA from 1.9 percent to 1.3 percent.

Legislation to eliminate the thrift charter was ultimately brought about by the overhang of the 1980s thrift industry meltdown. Volatile interest rates, regional economic shocks and a regulatory structure that provided incentives for the weakest institutions to pursue excessively risky strategies all combined to produce the most serious financial difficulties since the 1930s. Restrictions on the activities of thrifts limited these institutions mostly to a narrow asset portfolio of residential mortgages. Many analysts pointed out that requiring thrifts to concentrate their product base in a limited range of activities with smaller and smaller profit margins helped sow the seeds of the eventual collapse of savings and loans by effectively precluding the industry from diversifying its balance sheet to limit risk exposure. These same restrictions also placed the thrift industry at a distinct disadvantage compared with its less regulated competitors, which made increasing inroads into the mortgage lending business.

What About Banks?

In the 1980s, the nation's banking industry also went through its worst period of financial stress since the Great Depression. While not as severe as the thrift difficulties, the same set of circumstances also affected banks. Geographic restrictions (more onerous for banks than for thrifts but largely removed in 1994) and product restrictions both limited the ability of banks to pursue effective diversification strategies. And these restrictions also placed banking organizations at a disadvantage as less regulated competitors encroached on what was once considered traditional banking territory. Looking back at Chart 1, the relative position of U.S. commercial banks has also declined. And while banks are increasingly offering more and more off-balance-sheet products to their customers, even after ad-

Chart 2
Distribution of Thrift Profitability
(*Rank Based on Return on Assets, March 31, 1995*)

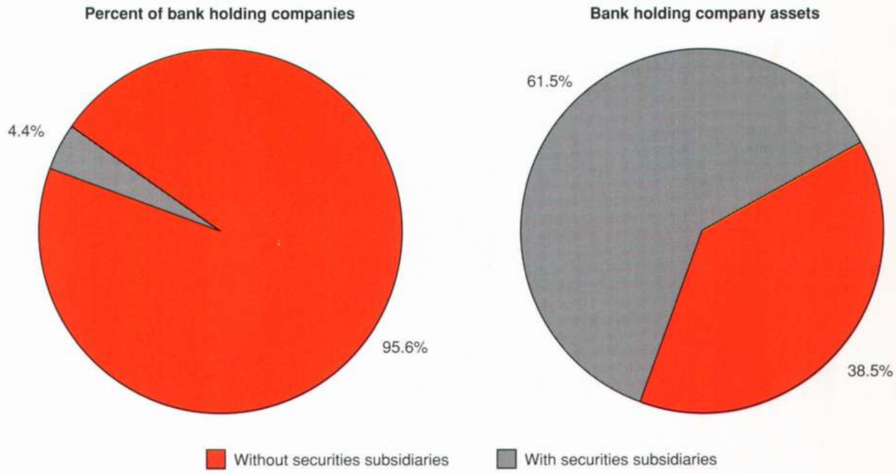


DATA SOURCE: Reports of Condition and Income, FFIEC 031-034.

justing for these types of activities, U.S. banks still show a slight decline in market share.

Legislation passed in the aftermath of the 1980s financial difficulties, however, seems to be moving the banking industry in the direction of even more restrictions on its activities. The prompt corrective action features of the 1991 FDIC Improvement Act, along with its standards for safety and soundness, have been characterized by some observers as efforts to micro-manage the banking industry. Some amount of regulation and oversight is needed at depository institutions that enjoy a federal guarantee of their liabilities. However, in light of the likely disappearance of the thrift industry, the debate today on banking reform focuses on whether some current restrictions on U.S. banking organizations are overly excessive and could lead the banking industry down the same road as thrifts.

Chart 3
Bank Holding Companies with Securities Subsidiaries, December 31, 1994



DATA SOURCE: Reports of Condition and Income, FFIEC 031-034.

Any Lessons for Banking Reform?

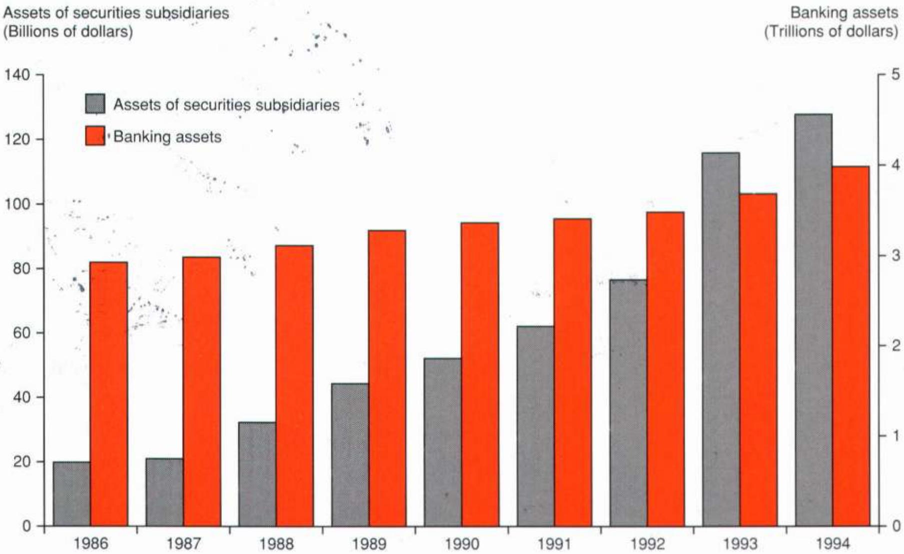
Following the removal of geographic restrictions, legislation was introduced in both the House and Senate in January 1995 to expand the permissible range of banking organizations' activities. One proposal, introduced by Congressman James Leach (R-Iowa) would repeal the Glass–Steagall restrictions on banking organizations' involvement in securities activities. A more sweeping reform proposal was put forth by Senator Alphonse D'Amato (R-New York), which would eliminate the separation of banking and commerce in U.S. banking markets and allow banks to pursue a full range of activities.

Banks and nonbank subsidiaries of bank holding companies may deal in and underwrite what are known as *bank-eligible securities*. These include obligations of the United States, general obligations of states and political subdivisions and certain types of municipal revenue bonds. The Federal Reserve has long supported the repeal of Glass–Steagall restrictions on banking organizations and, in fact, has granted increased latitude for bank holding companies to pursue securities activities. According to Section 20 of the Glass–Steagall Act, a bank may not be affiliated with a company that is "engaged principally" in underwriting or dealing in securities. The Board of Governors has interpreted this phrase as meaning that banks can be affiliated with nonbank securities companies if no more than 10 percent of the affiliate's total revenue is derived from underwriting and dealing in *bank-ineligible securities*, which include such items as one- to four-family mortgage-related securities, commercial paper in which the reporting company was an underwriter or dealer, debt securities and certain municipal revenue bonds. Those security subsidiaries that are involved in ineligible securities activities are commonly known as *Section 20 subsidiaries*, and, on a case-by-case basis, some have been authorized by the Federal Reserve Board to underwrite or deal in any type of debt or equity security (except mutual funds). In all banking organizations' dealings with securities activities, the Federal Reserve requires that sufficient firewalls be in place to insulate the insured commercial bank.

Securities activities represent a growth area for banking organizations that would help offset the declines in commercial banks' market share. This growth is, in part, the result of recent decisions by the Federal Reserve Board to broaden the range of securities activities permissible for nonbank subsidiaries. Chart 3 shows that only about 5 percent of all bank holding companies have nonbank subsidiaries engaged in some type of securities activities. But these institutions tend to be the larger organizations, since they represent more than half of all consolidated holding company assets. Even though limited in nature, securities activities at bank holding companies have expanded considerably. The assets of securities affiliates have increased rapidly, with average annual growth since 1986 of over 60 percent. This compares with average growth in bank assets over the same time period of 4 percent, as shown in Chart 4. Growth in the assets of nonbank subsidiaries engaged in other activities (such as mortgage banking and consumer financing) has been much more modest.

Under the Leach proposal, Section 20 of the Glass–Steagall Act would be repealed, which would permit banking organizations to expand their securities activities even further. Allowing banking organizations to engage more freely in securities

Chart 4
Assets of Securities Subsidiaries Versus Banking Assets



DATA SOURCE: Reports of Condition and Income, FFIEC 031-034, and FR Y-11AS report, Board of Governors of the Federal Reserve System.

activities would provide greater opportunities for banks to diversify and broaden their product base into more profitable areas. But does this reform go far enough? Currently, efforts to pass the Leach proposal have bogged down over the extent to which banking organizations can offer insurance products. Some observers think that even more freedom should be granted to banking organizations, along the lines suggested by Senator D'Amato, to place U.S. banking organizations on a more even competitive playing field in both domestic and international financial markets. While the debate is far from settled, even if modest reform efforts currently before Congress fail, U.S. banking organizations would likely find it more difficult to compete with their less regulated competitors. Product restrictions helped seal the fate of the thrift industry. A continuation of outdated restrictions on banking organizations would increase the likelihood of their following in the thrift industry's footsteps.

Conclusions

If legislation introduced in Congress is passed into law, then the nation will cease to have a separately defined thrift industry specializing in mortgage lending. Such a development would likely not affect housing finance, given the declining role of thrifts in this area. The demise of the thrift charter can be traced to the financial difficulties that surfaced in the 1980s. These difficulties, in turn, can be traced, at least in part, to the web of restrictions on activities that made it difficult for savings and loans to diversify their portfolios and compete effectively in financial markets. The fate of the thrift industry offers some lessons for efforts that are currently under consideration to expand the permissible range of bank activities. Banks, like thrifts, have returned to profitability. But banks, like thrifts, have also seen their traditional activities shrink in relative importance in financial markets. Allowing banking organizations to pursue an expanded range of activities would be an important step in ensuring that the banking industry in the United States does not travel the same road as the thrift industry.

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