# Deregulation: A New Future For Thrifts

*by Jan G. Loeys**

The nation's thrift institutions are among the businesses most severely hit by the recent combination of recession and record-high interest rates. During the last two years, the savings industry has suffered larger losses than the beleaguered auto and airline industries combined. Faced with the possibility of more losses this year, hundreds of thrift institutions may not survive.

A complex network of regulatory constraints and a sharp increase in both the level and variability of interest rates are the root causes of the industry's problems. The constraints, which were designed to promote low-cost mortgage financing, have made savings institutions vulnerable to interest rate fluctuations and to changing conditions in local housing markets. Removing restrictions that limit the ability of thrifts to adapt to changing economic circumstances is an essential element in any program to restore the viability of the thrift industry. Although thrifts face a difficult adjustment period, reversing or even delaying current deregulation efforts can only make thrifts worse off.

## EARNINGS CRISIS IN THE THRIFT INDUSTRY

Like other financial institutions, thrifts borrow money in the hope of lending it out at

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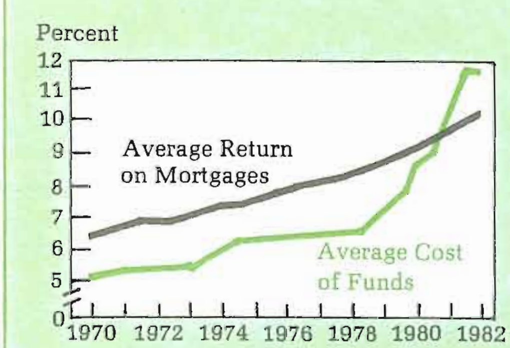
a higher interest rate.[1] Until a few years ago, the spread between the return on assets and the cost of funds amounted to a comfortable 1 percent to 1.5 percent (Figure 1). Unlike commercial banks, however, thrifts hold most of their assets in the form of long-term, fixed-rate mortgages. When interest rates rose unexpectedly in 1979, their mortgage income failed to keep up with their cost of funds. By late 1980, the spread (return on assets minus cost of funds) had turned negative, and thrift institutions were incurring heavy losses. Commercial banks were able to maintain their profitability by raising the interest rates on their loans as their cost of funds rose (Figure 2). Thrifts had to spend their accumulated reserves to cover their losses, and their net worth position dropped from $44.7 billion in December 1980 to $33.6 billion in August 1982. These aggregate data, while disquieting enough as they stand, hide the still more ominous fact that many individual institutions have used up almost completely their net worth and face liquidation or merger into stronger firms. Since the beginning of 1981, more than 700 thrift institutions, out of a total of 5,016, were merged or acquired by other institutions. Also, these net worth data are based on book values, and may overstate the financial strength of an institution (see NET WORTH AND THE BANKRUPTCY DECISION).

The problems of the thrifts are not apt to disappear overnight. Increasing competition from commercial banks and nonbank financial institutions will erode further their usual source of low-cost funds—passbook accounts. More and more depositors are demanding

[1] The term 'thrifts' usually includes credit unions as well as savings and loan associations and mutual savings banks. Credit unions are excluded here because they do not have nearly as high a proportion of mortgage loans and thus their earnings are not impaired to the same degree as those of other thrifts.

**FIGURE 1**

**AVERAGE RETURN DROPS BELOW AVERAGE COST OF FUNDS AT SAVINGS AND LOAN ASSOCIATIONS**




SOURCE: Federal Home Loan Bank Board Journal, November 1973 - May 1982, Tables S.4.8 and S.4.10.

**FIGURE 2**

**PROFITABILITY OF THRIFTS TAILS OFF SHARPLY**


SOURCE: National Association of Mutual Savings Banks, National Fact Book 1981, Table 51.

## NET WORTH AND THE BANKRUPTCY DECISION

In the thrift industry, the deposit insurance agencies — the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) — are the main agents that deal with failing thrift institutions. When should they declare a thrift bankrupt? In competitive markets, a good measure of a firm's efficiency is its profits. The present value of future profits (and losses) is what constitutes the value of a firm as a going concern. If a firm is not using its resources efficiently, its assets could find a more valuable use somewhere else. Selling the assets and liabilities will yield a premium over the firm's going concern value (assuming no liquidation costs). Thus, ideally, a firm should close down when its liquidation value exceeds its value as a going concern.

Under current regulations, the insurance agencies are required to take action whenever the book net worth of a thrift institution threatens to fall below a certain threshold, defined as a percentage of total assets. Book net worth is the difference between assets and liabilities as they appear on the balance sheet.

The relationship between this book measure and a thrift's going concern value, however, is tenuous at best. For one thing, book values reflect historical costs, such as the price paid or obtained at the time the asset or liability was first acquired. And book values do not necessarily provide information about future cash flows. For another, by concentrating on a firm's balance sheet, net worth measures tell us something about existing assets and liabilities but nothing about future investment and funding opportunities. By relying on book net worth criteria, the FDIC and FSLIC risk being too late when institutions are failing and too hasty when they are temporarily insolvent but have profitable opportunities in the long run.

The federal thrift insurance agencies are aware that their net worth measure can be misleading, and they prefer to underplay its importance. Currently they are considering alternative measures. One proposal is to focus on market net worth. This measure involves valuing assets and liabilities at their current market price. The market value of a financial instrument is the present value of the future cash flow it generates. This value will differ from the book value if the yield of the asset is different from the market rate. Thrift mortgage portfolios, when marked to market value, are heavily discounted because, on average, they earn less than the yield on new mortgages. This discount is a reflection of the earnings which thrifts lost because they held on to these low-yielding mortgages while the rate on new mortgages was rising.*

The difference between book and market value will be greater the longer the maturity and the larger the difference between current market rate and original contract rate. Given that the average maturity of thrift assets is longer than that of thrift liabilities, the market net worth of thrifts will be lower than their book value. Andrew Carron of the Brookings Institution made a tentative calculation of the market value of thrift net worth. He found that the market value had been declining since 1978 although the book value started to decline only after 1980. As of June 30, 1981, his estimate of market net worth was -$44.1 billion versus a reported book value of +$42.4 billion.†

Information on the market value of net worth is useful to thrift managers as an estimate of future net cash flows that are imbedded in the assets and liabilities acquired up to that moment. This estimate still does not correspond exactly to what we have termed the going concern value of a firm, however, since it excludes those assets and liabilities that the firm has not acquired yet but can be expected to acquire in the future. For thrifts in particular, since the new mortgages they are currently

(continued)

*See Richard W. Kopcke, "The Condition of Massachusetts Savings Banks and California Savings and Loan Associations," *The Future of the Thrift Industry*, Federal Reserve Bank of Boston, Conference Series No. 24, October 1981, p. 5.

†Andrew S. Carron, *The Plight of the Thrift Institutions*, Washington D.C., The Brookings Institution, 1982. Note that Carron is not unaware of the limitations of using market net worth data.

acquiring yield more than what they have to pay for new deposits, measures based on existing assets and liabilities underestimate the present value of future profits. The fact that many newly established thrifts are very profitable is certainly an indication that, without the burden of the past, thrifts would be profitable at this moment.

To judge the financial strength of a thrift institution, the FDIC and FSLIC must go beyond evaluating current assets and liabilities. Assessing a thrift's future viability requires a close look at investment opportunities in its market area, the expertise and efficiency of its management, and its ability to attract funds at or below market rates. The fact that most failing thrifts are acquired by firms that are willing to pay a premium over the market value of assets and liabilities does seem to suggest that there is optimism about the ability of troubled thrifts to become profitable in the future.

market rates of return on their savings. Thrifts must pay market rates or face losing their funding base to competitors like money market funds. Yet, thrifts are unlikely to be able to offset higher interest expenses by earning substantially higher returns on their assets. By late 1980, more than two-thirds of thrift mortgages still yielded less than 10 percent. Although new mortgages yield around 15 percent, the replacement of old mortgages has slowed down because of the current slump in housing and because people are trying to hold on to their low-cost mortgages.[2] Thus, thrifts appear to be in quite a fix.

Thrifts must have been aware of the risks they were taking by attracting short-term deposits and by making long-term loans. What made them take such risky positions? A major part of the answer lies in government regulations.

## HOW REGULATIONS HURT THE THRIFTS

Thrift institutions as they exist today are essentially a creation of Congress, which has long tried to encourage home ownership by promoting home financing.[3] Regulations defining what thrifts can and cannot do have created a very specialized kind of financial institution to support the housing industry. Prior to 1980, these regulations almost completely limited thrift portfolios to mortgages and U.S. government securities. In addition, regulations impose restrictions on the types of mortgage contracts which thrifts can make, such as maturity and loan-to-value limitations, and until recently they prohibited adjustments in mortgage rates.[4] There are also severe geographic constraints on lending areas. On the incentive side, thrifts have received certain tax benefits directly linked to the percentage of total assets they hold in the form of mortgages.[5]

By and large, these portfolio regulations grew out of previously existing operating conventions. Thrifts grew up as mutual organizations devoted to the financing of

[2] By mid-1981 the turnover rate of mortgages had dropped to 7.7 percent from a high of 13.1 percent in 1978. A recent law enforcing non-assumability of mortgages, however, should increase turnovers.

[3] Current federal regulations are mostly based on Congressional legislation in the 1930s, authorizing federal savings and loan associations (Home Owners Loan Act of 1931) and creating the Federal Home Loan Bank System (1932) and the Federal Deposit Insurance Corporation (1934).

[4] Loan-to-value limitations impose ceilings on the ratio of the size of the loan to the value of the house that is mortgaged. Adjustable mortgage loans were authorized in April 1981.

[5] Savings and loans receive a bad debt tax deduction equal to 40 percent of taxable income if they have 82 percent or more of their portfolio in "qualifying assets" consisting mainly of residential mortgages and U.S. government obligations. For every 1 percent of a portfolio in which qualified assets are below 82 percent, the bad-debt allowance is reduced by three quarters of 1 percent. For more details see Kenneth R. Biederman and John A. Tuccillo, *Taxation and Regulation of the Savings and Loan Industry,* Lexington Books, 1976, Chapter 2.

home construction in their immediate neighborhood.[6] Regulations brought legal force to what thrifts were doing already because they found it profitable. To finance their portfolios of long-term, fixed-rate mortgages, thrifts typically attracted savings deposits that had short-term maturities. Borrowing short and lending long was quite profitable because interest rates were stable and short-term rates were below long-term rates. This favorable interest rate environment lasted until the mid-1960s and made thrifts a booming and prosperous industry. Their assets grew from around $17 billion in 1935 to $111 billion in 1960, or twice as fast as the rate of inflation.

**Economic Conditions Change.** In 1966, the economic environment started to change. Short rates frequently rose above long rates and interest rates became much more volatile (Figure 3). With short rates relatively high, borrowing short and lending long ceased to be a sure way to make money. And with interest rates taking huge swings, thrift balance sheets and the housing industry both showed weakness.

Because most thrifts have locked themselves into fixed-rate assets, sudden upward movements in interest rates raise their cost of borrowing a lot faster than their average return on assets, squeezing their profit margins. But if interest rates decline, borrowers tend to pay off their loans and refinance at the lower rate. As a result, thrifts' yields on assets are more flexible downwards than upwards. Thrifts lose money when interest rates rise but they do not gain much when rates drop; the effect of volatility is not symmetric. Thus, on average, interest rate fluctuations impose a loss on thrift institutions.

Interest rate volatility also brought about more instability in the construction industry because the demand for housing is highly sensitive to mortgage rate fluctuations (Figure 4 overleaf). Since thrifts have been forced to concentrate their investments in mortgages and in limited geographic areas, they are highly dependent upon local housing markets.[7] Lack of sectoral and geographic diversification helps to explain why savings institutions in the depressed Northeast are worse off than those in comparatively vigorous areas such as Florida and California.[8]

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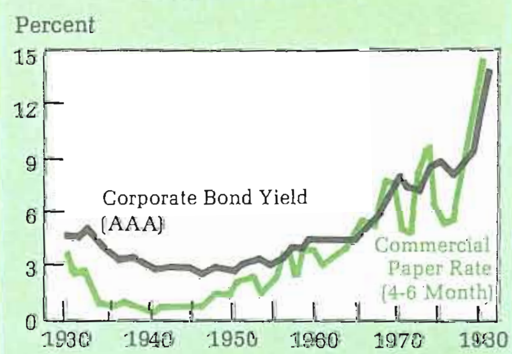
[6] Thomas G. Gies, Thomas Mayer, and Edward C. Ettin, "Portfolio Regulation and Policies of Financial Intermediaries," p. 177, *Private Financial Institutions*, a Series of Research Studies Prepared for the Commission on Money and Credit, Prentice Hall, Englewood Cliffs, 1963.

[7] The existence of a secondary mortgage market, however, makes it possible to reduce their exposure to local conditions by allowing them to take part in mortgage pools that consist of loans from different geographic areas.

[8] Insured S&Ls in the New York FHLBB district had an average net income-to-assets ratio of -.36 percent over the 1979-81 period, compared with .22 percent for the San Francisco district and .02 percent for the nation as a whole.

**FIGURE 3**
**SHORT RATES RISE ABOVE LONG RATES AS VOLATILITY INCREASES**




SOURCE: Economic Report of the President, 1982, Table B-67.

Commercial banks suffer much less from rate volatility, since they usually are not as dependent upon a single local industry.[9]

Regulations that restrict investments to mortgages thus are harmful to thrifts because they make these institutions vulnerable to interest rate fluctuations and to adverse conditions in their local housing market. When the interest rate environment started changing in 1966, regulators did not recognize that thrifts needed the opportunity to match more closely maturities of assets and liabilities and to diversify their assets in order to protect themselves against interest rate volatility. Instead, regulators decided to try to insulate thrifts further from the market. In 1966, Congress passed the Interest Rate Control Act which empowered the Federal Home Loan Bank Board (FHLBB) and the Federal Deposit Insurance Corporation (FDIC) to set deposit rate ceilings for all thrifts under their jurisdiction. These agencies were to coordinate their actions with the Federal Reserve's administration of Regulation Q, which imposes ceilings on commercial bank deposit rates. In this kind of regulatory environment, it was thought, thrifts would not lose funds to banks which had the flexibility to pay current market rates because of their shorter asset maturity.

For some time, Regulation Q was able to restrain thrift borrowing costs, but at the expense of more variable deposit flows. Each time market interest rates rose above the ceiling rate on thrift deposits, depositors in search of higher yields pulled their savings out of the thrifts and invested them with an unregulated institution or even lent directly to borrowers. Increased interest rate volatility in the 1970s created several episodes of this so-called *disintermediation* and caused severe liquidity problems for the thrifts. Although these rate-ceiling regulations were intended to help thrifts, they actually harmed these institutions over the longer run by preventing them from adjusting their policies to suit the new environment of volatile interest rates and increasing competition.

**What if Thrifts Had Not Been Regulated?** This is not to say that if thrifts had been left unregulated, they *all* would have started to match maturities and to diversify their assets *as early as 1966*. Adapting to changing economic conditions is no easy task. Uncertainty about what changes are actually occurring and how to react to them makes it difficult to make timely decisions. However, there were several episodes of sharp interest rate movements during the late 1960s and early 1970s, and most thrifts no doubt would have learned the benefits of diversification and the costs of maturity mismatches by 1979, when interest rates became still more volatile.[10] As a result, fewer institutions would have been hit as hard by recent interest rate fluctuations.

Support for this view can be found by comparing thrifts with institutions not subject to these constraints. Commercial banks, while they also were subject to Regulation Q, had wider asset powers and were able to diversify their assets and to eliminate most of their maturity gap.[11] Their profits remained relatively unaffected by recent interest rate surges, while thrift profits took a dive (Figure 2, page 16).

Canadian trust and mortgage loan companies provide another interesting com-

[9]Smaller banks in states that severely limit geographic expansion, however, can also suffer from a lack of diversification when a single industry dominates their lending area.

[10]In fact, the thrift industry has been lobbying for a variable rate mortgage instrument since the early 1970s, although what they were requesting probably would not have been "variable" enough to have protected them fully against recent interest rate fluctuations.

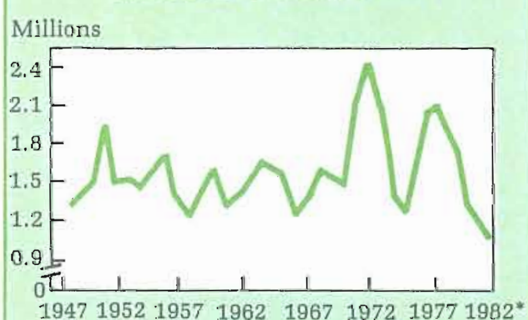
[11]For some evidence see Mark J. Flannery and Christopher James, Market Evidence on the Effective Maturity of Bank Assets and Liabilities, Mimeo, Federal Reserve Bank of Philadelphia, August 1982.

parison.[12] Until 1978, most of their deposits had a maturity of five years. These institutions, although they specialized in mortgages that were amortized over 20 to 30 years, adjusted the rates on these mortgages every five years, so that there was no gap between asset and liability maturities. When customers started buying shorter term certificates in 1979, Canadian mortgage lending institutions issued one-year or two-year rollover mortgages, thereby again matching maturities. The few institutions that did not reduce the effective maturity of their mortgage assets incurred substantial losses and had to be merged into stronger firms. Most Canadian thrifts, however, avoided problems caused by interest rate fluctuations.

In short, stability in interest rates and the positive spread between long and short rates before 1966 made it profitable to borrow short and lend long. Portfolio restrictions that sanctioned this policy were not resisted by the thrift industry. Increasing interest rate volatility since 1966, however, pressured financial institutions to match maturities and to diversify their assets. Investment regulations and deposit rate ceilings prevented thrifts from adjusting their policies to this new economic reality and left them highly vulnerable to interest rate fluctuations and to local housing conditions. Thus a sizable body of opinion now favors a move toward deregulation. Disagreement remains, however, on how much to deregulate and how to handle the transition period.

[12]For more details see Robert W. Eisenmenger, "The Experience of Canadian Thrift Institutions," in *The Future of the Thrift Industry,* Federal Reserve Bank of Boston, Conference Series No. 24, October 1981, pp. 112-139.

FIGURE 4
**ANNUAL HOUSING STARTS ALSO BECOME MORE VOLATILE**




*1982 is an average based on the first eight months.

SOURCE: Data Resources, Inc.

## DEREGULATION: CURE OR CALAMITY?

In response to recurring crises in the financial sector, the government has on several occasions commissioned studies on financial reform. These studies, such as the Report of the Hunt Commission (1970) and the FINE study (1976), concluded that only a lifting of deposit rate ceilings and a removal of many other regulatory constraints could assure the viability of the thrift industry.[13] Despite these recommendations, it took several major liquidity crises to bring home the message that most thrifts would not survive if regulations were not relaxed.

**First Attempts at Deregulation.** The initial response of the regulatory agencies to the problems of the thrifts focused on the ability of these institutions to attract deposits at market rates. Rather than removing existing Regulation Q ceilings, regulators authorized new types of liabilities without deposit rate

[13]For a short survey of these studies, see John Tuccillo and Kevin Villani, "Current Initiatives and Reform of the Housing Finance System," in *Occasional Papers in Housing and Community Affairs,* Vol. 9, HUD, July 1981.

ceilings or with yields linked to rates of U.S. Treasury obligations of comparable maturity. These new deposits were not all introduced at the same time (Figure 5). A long-term deposit with no interest rate ceiling was authorized only in 1982, four years after the introduction of the six-month money market certificates.

In reaction to complaints by thrifts that these new instruments merely raised the cost of borrowing without improving their earnings capacity, Congress started expanding thrift asset powers. Part of this thrust was realized in the Depository Institutions Deregulation and Monetary Control Act of March 1980. The Act allowed savings and loan institutions to invest up to 20 percent of their assets in consumer loans, commercial paper, and corporate debt securities, while mutual savings banks were authorized to make commercial, corporate, and business loans up to 5 percent of their assets. In addition, the Act established the Depository Institutions Deregulation Committee to oversee the gradual phase-out of interest rate ceilings over a six-year transition period. More recently, the Thrift Institutions Restructuring Act of October 1982 authorized savings and loans to make commercial loans up to 10 percent of their assets and further broadened their asset powers.[14] The Federal Home Loan Bank Board, in another regulatory change, allowed all institutions it regulated to issue mortgages with payments that can be adjusted on a regular basis. The interest rate on these Adjustable Mortgage Loans (AMLs) is tied to any index that is readily verifiable by the borrower and beyond the control of the lender. The effective maturity of an AML is equal to the period over which the interest rate is fixed. Since their nationwide introduction in April 1981, AMLs have grown in popularity to the point where they now constitute more than half of all newly issued mortgages.

These new asset and liability powers constitute definite progress in loosening regulatory restraints on thrifts. But they cannot produce a quick fix for the industry's problems. Thrifts will have to invest time, energy, and resources in gearing up to take advantage of these new powers. Not all institutions will choose to get involved in each of these newly permissable areas. But some diversification seems almost a necessary condition if thrifts are to regain their long-run viability.

**There Are No Alternatives to Deregulation.** Although the need for deregulation seems clear, not all thrift industry representatives are equally convinced of its merits. Some thrift representatives, noting that their net worth started declining at the same time that regulators began relaxing deposit rate ceilings, view deregulation more as the cause of their problem than as the solution. They argue that the government should extend deposit rate ceilings, reserve requirements, and other regulations to unregulated competitors such as money market mutual funds.

The history of financial controls suggests that, although such a policy may have some of the intended effects in the short run, in the long run it will be ineffective. Whenever authorities try to limit voluntary exchange, people always seek ways to circumvent these controls. The emergence and continued popularity of commercial paper, negotiable certificates of deposit, repurchase agreements, Eurodollar markets, and money market mutual funds are partly due to the fact that each allows people to escape, to some degree, such regulations as deposit rate ceilings. And some of the same instruments allow institutions to avoid reserve requirements. Forcing money market mutual funds to operate under the same rules as commercial banks and thrifts would create incentives for financial

[14]The Act permits greater thrift asset investments in nonresidential real property, state and local obligations, consumer loans, tangible personal property, education loans, and small business investment corporations.

FIGURE 5
## LEGISLATION AND REGULATION HAVE CREATED NEW FORMS OF LIABILITIES

| Date in effect | Maturity | Ceiling* based on | Minimum deposit | Comments |
|---|---|---|---|---|
| June 1, 1978 | 6 months | 6-month Treasury Bill † | $10,000§ | Called "Money Market Certificate". |
| July 1, 1979 | 2½-3½ years ‡ | 2½ year Treasury Security † | No minimum | Called "Small Savers Certificate". |
| October 1, 1981 | 1 year | 70 percent of 1-year Treasury Bill rate | No minimum | Called "All Savers Certificate"; interest is tax-exempt up to $1,000 for individuals and $2,000 for joint returns; expired December 31, 1982. |
| December 1, 1981 | 1½ years or more | No ceiling | No minimum | IRA and Keogh accounts only. |
| May 1, 1982 | 3½ years or more | No ceiling | No minimum | First step in Regulation Q phase-out schedule. |
| May 1, 1982 | 91 days | 91-day Treasury Bill † | $7,500§ | |
| September 1, 1982 | 7-31 days | 91-day Treasury Bill †; removed January 5, 1983 | $20,000§ | |
| December 14, 1982 | Available upon demand | No ceiling | $2,500 | This "Money Market Deposit Account" allows limited third-party transfers. |
| January 5, 1983 | Available upon demand | No ceiling | $2,500 | Called "Super NOW Account"; allows unlimited checking, but is subject to a 12 percent reserve requirement. |

*The actual calculation of the deposit rate ceiling is quite complicated. For details see Table 1.16 in any recent Federal Reserve Bulletin.

†Includes a ¼ of 1 percentage point advantage for thrifts over commercial banks.

‡Initially the maturity was 4 years or more. It changed several times until it was fixed at 2½ - 3 years on May 1, 1982.

§Reduced to $2,500 effective January 5, 1983.

markets to come up with still other unregulated liabilities.

Other thrift spokesmen feel that their current problems are temporary, and that all will be well again when interest rates come down from their historically high levels. They argue that since high and variable interest rates are the government's fault and since thrifts were essentially excercising a public mandate to specialize in mortgages, the government should subsidize thrift losses. Currently, government agencies provide some form of aid but focus mainly on merging failing thrifts into new entities (see DEALING WITH FAILING THRIFTS).

Several aid programs have been suggested by the thrift industry. Some involve direct aid in the form of outright cash infusions, subsidized loans, or mortgage warehousing (purchase of low yielding mortgages at face value). Others require regulators to assure that thrifts are able to maintain a certain minimum net worth position.[15] Thrift arguments for aid are understandable, but the fact remains that a subsidy does not remove the ultimate cause of their problems—regulation. If the government bails out the thrifts without loosening regulatory constraints, they will still be vulnerable to future interest rate fluctuations.

The current programs to aid thrifts are designed to smooth the transition to a deregulated environment. After all, there does seem to be something to the argument that thrift institutions are not fully responsible for the dilemma they find themselves in. Perhaps more significantly, if no assistance were forthcoming, the severe difficulties of some individual institutions could have a spillover effect on others, perhaps including financial firms outside the thrift industry.

Still another reaction to deregulation is that it has happened too fast and has not proceeded in an even-handed manner. Thrifts' managers often feel that recent efforts at deregulation have not been well planned and that this is the worst of all times to change the industry. The current earnings crisis makes it difficult for thrifts to pay market rates on deposits and to invest resources and acquire skilled personnel to take advantage of their new asset powers.

No one can deny that the thrifts face high costs of adjusting to the new environment, yet it seems clear that the faster the financial sector is deregulated, the more quickly thrifts will be able to protect themselves against changing interest rates, cycles in housing construction, and outside competition. The losses incurred in the past are sunk and cannot be recouped by postponing deregulation, but *they can occur again.* The longer thrifts are restricted in their investment and funding powers, the more customers they will lose to commercial banks or to unregulated competitors such as Merrill Lynch, Sears, and others.

If stretching out deregulation over time has pitfalls, so does focusing on certain assets and liabilities for special treatment. The initial focus of recent deregulatory efforts was to relax deposit rate constraints on short-term liabilities. Although this step did help to lessen the outflow of savings towards money market mutual funds, it made the cost of borrowing more sensitive to interest rate fluctuations and did not allow thrifts to narrow their maturity gap. In short, it is not clear that this regulatory change helped rather than hurt the thrifts.

Some thrifts have argued that regulators should have given priority to new asset powers and should have postponed any further lifting of interest rate ceilings. Such a move indeed might have prevented a rise in the cost of funding, but it also would have prolonged the maturity gap (because thrifts would have been less able to extend long-

[15] The Net Worth Certificate Act, as part of the Garn-St. Germain Depository Institutions Act of 1982, authorizes the FDIC and FSLIC to purchase capital instruments of thrifts with a net worth of less than 3 percent of assets.

# DEALING WITH FAILING THRIFTS

Deposits up to $100,000 at most depository institutions are insured by either the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings and Loan Insurance Corporation (FSLIC). Not surprisingly, these insurance corporations are the main government agencies in charge of dealing with failing thrifts. The FDIC and FSLIC can follow several alternative procedures when confronted with a troubled thrift. First, they can choose to liquidate the institution, acting as a receiver of the assets and making direct payments to insured depositors. Second, they can help the institution to survive on its own by providing subsidized loans or direct aid. Third, they can take over the institution, arrange for new ownership and management, or facilitate a merger, thereby protecting all depositors.

The first alternative — selling off the assets and paying off the liabilities — is a solution that the insurance corporations prefer to avoid because this option is usually the most costly. At liquidation, the tangible nonfinancial assets (such as buildings) will probably yield less than replacement cost, while the intangible assets (expertise, reputation) are destroyed in the liquidation. The liabilities, on the other hand, will have to be paid off at face value, not at the value they have to the institution as a going concern. The benefit of marking liabilities to market is lost. By mid-1981, this difference added up to an estimated $24.7 billion for the thrift industry as a whole.*

To avoid the high costs of liquidation, the FDIC and FSLIC usually have tried to provide direct assistance or to arrange a merger. Direct aid can take the form of outright cash grants, subsidized loans, or mortgage warehousing (purchase of low yielding mortgages at face value). To be effective, an aid program must be set up as a temporary device to help an institution bridge some transitional adverse conditions and should only be granted to thrifts that have a clear prospect of becoming profitable in the future. Compared with liquidation, direct assistance leaves insured depositors equally well off, but it provides a subsidy to uninsured depositors, to the owners, and to management; and if financial institutions expect the government to cover their losses each time things turn bad, they will be more apt to take excessive risks. To circumvent this problem, FDIC/FSLIC aid programs usually require increased stockholder participation, profit-sharing with the insuring agency, or increased supervision of management.†

A third approach that the insuring corporations are now using more frequently is merger of failing thrifts into healthier organizations. If the market net worth of the failing institution is negative, the price that the acquirer will pay is likely to be negative also: the FDIC/FSLIC will have to subsidize the acquisition. There are reasons to believe, however, that the acquiring firm will be willing to pay a premium above the failing thrift's going concern value. First, given that geographic constraints have created a multitude of small thrifts operating at less than optimal scale, a merger could lead to economies of scale.‡ Second, if the acquiring firm is not a thrift or operates in a different geographic area, diversification gains could be realized. Third, if the acquiring firm has superior management, the new combination could raise earnings due to increased efficiency. Fourth, nonthrifts could be attracted by the tax advantages that thrifts enjoy.§

To minimize the impact on their insurance funds, the FDIC/FSLIC must try to get the best price for the thrifts they put up for sale. This approach explains the insurers' recent efforts to attract not only healthy thrifts but also commercial banks, out-of-state institutions, and even nonfinancial firms as potential acquirers of failing thrifts.

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*Andrew S. Carron, *The Plight of the Thrift Institutions,* p. 19.

†See Paul M. Horvitz and R. Richardson Pettit, "Short-Run Financial Solutions for Troubled Thrift Institutions," *The Future of the Thrift Industry,* Federal Reserve Bank of Boston, Conference Series No. 24, 1981, pp. 44-67.

‡For some evidence on these economies of scale, see James E. McNulty, "Economies of Scale in the S&L Industry: New Evidence and Implications for Profitability," *Federal Home Loan Bank Board Journal,* February 1981, pp. 2-8. Andrew Carron calculated that more than 400 on average smaller thrifts should be able to save themselves by expanding through voluntary mergers (Carron, Chapter 2).

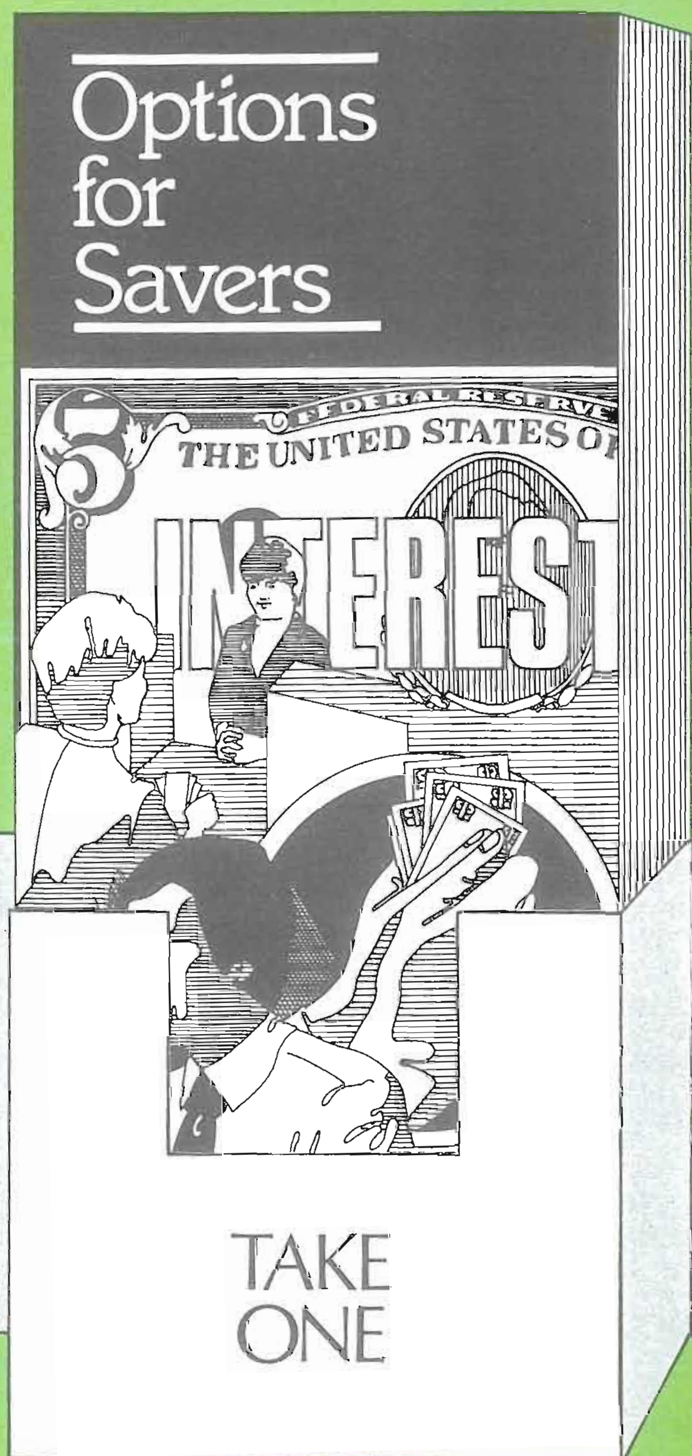
§John T. Mingo, "Short-Run Structural Solutions to the Problems of Thrift Institutions," *The Future of the Thrift Industry,* p. 94.

term liabilities). In addition, retaining ceilings would have made it difficult for thrifts to attract sufficient funds. Thrifts would have had the power—but not the funds—to make new investments. And while profits might have increased, the source of such a gain would be a continued subsidy from small savers who do not have the opportunity to escape the interest ceilings via a money market fund. Given the disruptive nature of an unbalanced process of deregulation, across-the-board reductions in regulations are preferable to deregulating one asset or liability at a time.

## CONCLUSION

The current depressed condition of the thrift industry is the result of adverse economic conditions and years of regulatory constraint that left the thrifts unprepared for high and volatile interest rates, a slump in housing, and competition from other institutions. To regain their long-run viability, thrifts must be able to protect themselves by diversifying their assets, paying market rates on deposits, and matching maturities.

Many thrift institutions may not survive the long and hazardous road to a competitive financial system, but there is no alternative. Prolonging deregulation or deregulating selectively will only cause thrifts to lose many customers to nonregulated firms. Broadening regulations to include currently unregulated competitors would be ineffective, because markets always seem to find ways to circumvent financial controls. Providing aid without relaxing regulations would merely alleviate current thrift losses; it would not remove the ultimate cause of their troubles.




# New from the Philadelphia Fed

This new pamphlet outlines some of the many savings options currently being offered by depository institutions. Copies are available without charge from the Department of Consumer Affairs, Federal Reserve Bank of Philadelphia, P. O. Box 66, Philadelphia, PA 19105

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