A NOTE ON THE PLIGHT OF THE THRIFTS

by M.C. Findlay and R.V. Eastin

"We have waited for interest rates to fall, but we can wait no longer."

Roy Green, chairman
U.S. League of Savings Associations
(see Bibliography 20 at end of article)

Thus far in the 1980s, the plight of the thrifts has not been a happy one. By the summer of 1981, Bernstein-Macaulay was estimating that the S & L industry mortgage portfolio had a book value of $500 billion but a market value of only $400 billion. This $100 billion loss was covered by only $30 billion in equity and reserves. The only change in this scenario by the spring of 1982 was that accounting losses had reduced the latter dollar figure to the mid-20s.

The threat of substantial insolvency problems in the industry has helped to relax restrictions on interstate and even interindustry mergers. In addition, borrowing and capital requirements have been loosened, loss write-off periods have been lengthened, and a tax-exempt ("All-Savers") certificate has been authorized. By any standards, a fairly massive Federal rescue effort is underway for this industry (2, 4, 15, 16), and a larger one has been requested (20).

The thrift industry stoutly resists the application of the term "bail out" to this effort and contends that its historic task has been to encourage housing by assembling low-cost deposits to lend as mortgages. The combination of a high interest rate environment and consumer pressure caused deposit ceilings to be lifted, and the industry's cost-of-funds rose more rapidly than new, rate-sensitive mortgages could be added to the portfolios. The industry claims to be in a temporary condition until its mortgage yields get back into line with its liability costs. Government assistance is seen as the most efficient way to bridge the gap. Observers claim, however, that with the need to reindustrialize America, housing should no longer receive special consideration.

With Federal funds at stake, the quality of economic analysis in this debate can be expected to be poor. Furthermore, the literature of the institution is still largely mired in a partial equilibrium, semi-efficient market framework. This paper reinterprets the plight of the thrifts in an efficient market framework and draws some policy conclusions.

View On An Efficient Market

The one-price law of markets prevails in an efficient market, and there are no *ex ante* windfalls. If it is assumed that thrifts both buy and sell loanable funds in such markets, several conclusions emerge:

1. *The mortgage rate is and was unsubsidized.* The tax laws may well encourage owner-occupied housing by allowing mortgage interest and property taxes to be deducted and not requiring the imputation of rental income. Furthermore, thrifts may possess some informational processing economies in homelending. However, the presence of banks, insurance companies, and other lenders with a broad range of portfolio choice in the mortgage market would raise serious doubt that mortgage yields diverged significantly from those of the capital market as a whole (for example, see 25, chapter 9). In this context, the portfolio losses have little to do with "subsidizing" mortgages, but reflect the result of borrowing short and lending long during a period of substantial unanticipated inflation (1).

2. *Bygones are bygones on the existing mortgage portfolios.* While it may be possible to depict market expectations about short-term rate movements from the term structure, long-term rates at a given point in time are essentially a fair game. The downsloping yield curve seen

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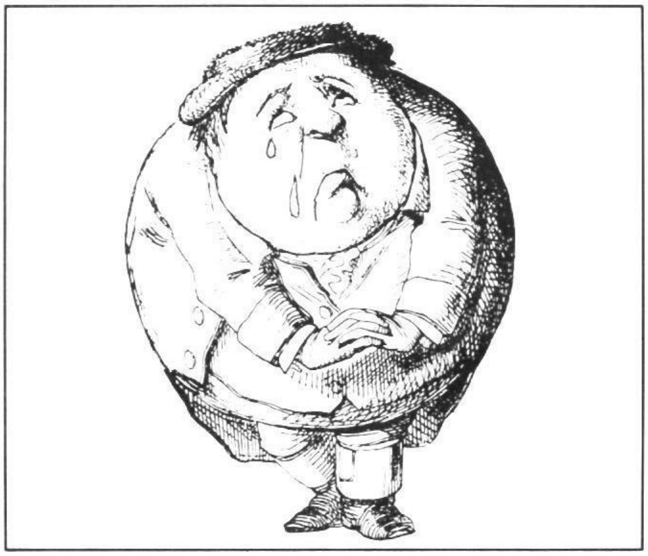

so far in the early 1980s may promise some cash flow relief to the thrifts on the near-term cost of their liabilities if short rates decline, but it promises no expectation of a reduction in their loss on the existing long-term, fixed-rate mortgage portfolio. In other words, the $100 billion loss mentioned earlier can be viewed as an unbiased estimate of a wealth loss.

3. *Except for spare capacity or joint production, new lines of business indicate only normal profits at the margin.* Some participants in the thrift industry seem to feel that losses on the mortgage portfolio can be made back through the employment of broadened lending powers (for example, trust business, consumer loans). Yet each of these markets would appear competitive, such that a new entrant could expect only normal profits. As discussed here, greater profits can only be expected on such business if there is some jointness in production with the thrifts' existing business.

4. *Rate ceilings do not lower the cost of funds to thrifts at the margin and never have.* When a homogeneous productive input (loanable funds) is obtained from several sources simultaneously, it must follow that the price of the last unit purchased from each source is the same in equilibrium. Rate ceilings have the economic effect of creating a partial monopsony cartel (23) in which the explicit dimension of cost (that is, rate paid) is fixed, but the implicit dimensions (for example, branches, operating hours) are not. What happens is that members of the cartel compete along the uncontrolled dimensions until they dissipate all of the rents at the margin (13, 21, 22, 26). With price determined at the margin, this result ties back into the assertion of an unsubsidized mortgage.

5. *Rate ceilings only lower the cost of funds on the average under restrictive assumptions.* In the first place, it would be necessary to encounter economies of scale (that is, decreasing average costs) over at least some range of operations. It seems unlikely that significant economies exist in the paying of interest (explicit return) per se, but the implicit return (for example, branches, advertising) has been found to involve economies of scale (3, 5, 6, 7, 8, 10, 11, 12). The existence of economies of scale is necessary, but not sufficient, to guarantee inframarginal returns. In this view, if there is an optimal scale, competitors enter at this scale until normal profits only are earned at optimal scale and less-than-normal profits are earned at any other scale. In practice, however, the restrictions placed on raising capital for new thrifts (for example, the prohibition of the payment of underwriting fees and the ownership distribution requirements), combined with the restrictions on expansion by existing associations, could have operated effectively to preclude any potential competitor from entering and quickly attaining optimal scale.

Theoretical Implications

From this rather unconventional view of the thrift industry, several disagreements with the existing literature may be noted:

1. *Thrifts cannot have been guilty of "mispricing" mortgages if they were price-takers.* Charges that thrifts misestimated the course of long-rates or attempted to maintain a constant markup over their deposit costs in pricing mortgages [that is, Kaufman's definition of the "solvency problem" (19)] are meaningless in this context. Speaking *ex post,* one can only say that the thrifts suffered the misfortune of being in the wrong business at the wrong time. The most serious charge of *ex ante* error would be levied against those thrifts which, thinking they could outguess the market on the future course of long rates, further unbalanced the maturity structure of their portfolios to speculate (generally to their *ex post* regret).

2. *If there are and were inframarginal rents from rate ceilings, they probably have gone to offset windfall portfolio losses rather than to subsidize mortgages or as excess thrift profit.* One should consider a scenario of the last decade of thrift experience *without* inframarginal effects. The latter implies, operationally, that thrifts would not only be paying a fair market rate for funds obtained at the margin, but also on the average (for example, that there were no little old ladies with dormant million dollar passbook accounts). The substantial rise in both long and short rates over the 1970s would have caused a massive rise in the cost of all funds obtained, as well as substantial opportunity losses on the mortgage portfolios. Finally, thrifts are rather thinly capitalized. Intuitively, one would expect a great many thrifts to be in trouble long before now under this scenario.

Only because of the unique nature of the thrift industry could such a situation exist even in theory (14). Deposit insurance makes the smaller saver indifferent to the financial condition of the association. The lending and merger policies of the FHLBB also desensitize the larger depositor, although the less secure institutions experience increasing difficulties obtaining this money during periods of stringency. Due to limited liability, shares of stock thrifts in even the worst shape would continue to command a price, as an out-of-the-money call option on an underlying asset of high variance.

The overall stability of this model leaves much to be desired. A situation where a windfall asset loss that had already occurred was being made up by a rent on regulated accounts, which could only be earned over time, is being postulated here. The latter must have proceeded for a given period of time before the former would have been fully compensated. The two are connected only in the sense that the older associations will tend to be larger and enjoy the greatest economies, while also having the largest proportion of low-rate mortgages.

Finally, as rate ceilings were legally removed or became *de facto* irrelevant, greater emphasis was placed on explicit return where few scale economies exist. Newer thrifts are found to be employing high explicit cost funds to act as mortgage brokers or even to invest in money market instruments (24). The older and larger associations under these circumstances retained the losses on their asset portfolios but lost the benefits of the ceilings to make them up.

3. *Court and legislative decisions have exacerbated the mortgage losses of the thrifts.* The Wellenkamp decision in California essentially voided the alienation and due-on-sale clauses of mortgages in that state; similar decisions in Federal court are currently being appealed. As a result, existing low-rate mortgages have become assumable. From the borrower's standpoint, these decisions have served to extend the maturity of an in-the-money call option from, perhaps, an average of 5-6 years up to as much as 30 years. With value preservation in efficient markets, the borrower's gain is a measure of the thrifts' loss.

Policy Implications

This model provides the following implications for public policy:

1. *The allowance of more flexible mortgages would seem desirable, but for somewhat different reasons than are often given* (17, 18, 24). In the first place, what has traditionally been called interest rate risk in the analysis of fixed-rate securities has become almost exclusively "unanticipated inflation" risk in recent years. The former was often discussed loosely in terms of interest rates fluctuating and the household sector having a fixed income and poor ability to forecast rates. The borrower would prefer a fixed-rate mortgage, and the thrift institution was viewed as providing a valuable maturity intermediation service.

Of course, financial markets and thrifts have also been poor forecasters over the post-war era. To the extent that rate changes are driven by unanticipated inflation, a borrower whose income and house price responded to inflation would find his/her net wealth subject to less variance if those debts also responded to inflation. In this context, the maturity intermediation of fixed-rate borrowing actually results in the creation of speculative risks (that is, uncovered options) and is of dubious social value (9).

The new mortgages contain most of the borrower advantages that have been won in the courts and also those viewed as likely in the future. This is a very rational response by the industry. It is similar to an auto company which, after constantly being forced to recall its cars to install consumer options for free, concludes that its only course of action is to sell all of its cars "fully loaded." In a competitive market, of course, all of these "consumer protection" features ultimately will be priced.

The shift of both inflation and legal risks to the borrower by the new instruments can be justified on another basis as well. To the extent that borrowers, as a group, may have more control over the political process than thrifts, then the former may see increases in inflation or erosion of the rights of contract as advantageous. They may reward those in the political system who confer such benefits on them and consequently create the potential for moral hazard for the thrifts. The new instruments tend to reduce this potential.

2. *A broadbased market rate, instead of a posted-price or cost-of-funds index, would seem the preferred basis for mortgage debiting rates.* In a purely efficient market, it would not matter which debiting interval or debiting index were chosen; competition over time would force the resulting instrument to be "correctly" priced. In the real world, there are advantages to using a broadbased, market-determined rate of equivalent maturity for the debiting index, such as a government security yield or average. First, if rates are changed every six months for example, then a rate on six-month instruments would have logical appeal as an index. Second, to prevent the appearance of manipulation a broadbased market rate would appear to be desirable. Finally, the cost-of-funds indexes, often employed in variable-rate contracts, are technically flawed. As the mix of funds raised by thrifts moves in the direction of higher explicit/lower implicit cost sources, the cost-of-funds index, which measures only the former, will rise no matter what has happened to interest rates. Likewise, as thrifts are able to obtain funds at the tax-exempt rate, the measured cost may fall, again without reference to a change in interest rates. This index appears to be a bizarre basis for writing debt contracts.

3. *The actual form and extent of Federal assistance to the thrift industry clearly involves value judgments and reflects a political question.* Nevertheless, it is possible to give a rough classification of the alternatives. A reduction in the inflation rate would clearly benefit thrifts without any cry of "bail out." The exploitation of existing economies of scale might benefit them at the expense of no identifiable victim. Those who have been enriched unexpectedly might be made to contribute, as well as those who historically have played the latter role. Finally, either because it contributed to the problem or because the breakdown of the thrift industry would have substantial macroeconomic effects, at least in the short run, the government itself might play a role.

Extensive merger and expansion of powers would appear to be the cheapest source of thrift relief. It is generally believed that unexploited economies of scale with respect to financial institutions exists. At the least, the thrifts would appear to possess an excessive capacity to pursue their historically limited function in a deregulated environment. The prospect of merging with banks, going across state lines, turning deposit production branches into loan production operations as well, and the like, holds some prospect for profit relief. In any event, the removal of any artificial regulatory barriers to optimal scale would appear to be one of the cheapest solutions to the plight of the thrifts.

The current efforts at a Federal preemption of state jurisdiction over mortgage terms (for example, to override Wellenkamp) would appear to have some justification. Questions of wealth distribution are difficult to assess in a neoclassical economic framework. To the extent that these decisions conferred windfalls on existing borrowers, and especially to the extent that some or all of this must ultimately be paid by the Treasury, a case for overriding the decision can be made.

Beyond this point, the options become ambiguous. If one were to make the heroic assumption that all of the money remaining in passbook and other low-rate accounts were there for purposes of convenience yield (that is, no naive savers), which would give rise to inframarginal thrift profit, then a case could be made against raising the ceilings and the cost of these accounts. An example of the market's propensity to clear, however, is given by the surprising amount of passbook money which has gone into the tax-exempt certificates because the rate is higher even for low-bracket investors. Failing this, the final resort is to direct government assistance, which is beyond the scope of this model.

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